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Foreign Investments in the Kaliningrad Region: Diagnostics of Status, Support Measures and Impact on the Investment Environment in the Region



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Series of Economic Bulletins

**Foreign Investments in the Kaliningrad
Region: Diagnostics of Status, Support
Measures and Impact on the Investment
Environment in the Region**

This is the next publication in the series of Economic Bulletins, issued under the framework of one of the directions of implementation of the European Commission project EUROPEAID/114287/C/SV/RU "Support for Regional Development of Kaliningrad". The purpose of this Bulletin is to disseminate experience and search for mechanisms and forms of assistance to develop the export activities of Kaliningrad enterprises. The potential contribution of the Project and of the Regional Development Agency in the support to export from the Kaliningrad Region is considered.

The Bulletin has been prepared by experts from the European Commission project EUROPEAID/114287/C/SV/RU "Support for Regional Development of Kaliningrad" and the Regional Development Agency, S. Klessova, A. Yershov, A. Usanov, and A. Kharin.

The publication is designed for a wide range of specialists.

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Introduction

In most countries, implementing market reforms in their economies, foreign investments are regarded not just as buildup of the countries' investment resources and an opportunity to attract advanced technologies and managerial know-how. In today's world, foreign investments are an efficient way of expansion of export potential and involvement of national manufacturers in the system of international economic relations. Therefore, in conditions of the Kaliningrad Region, where future economic development is currently a subject of violent polemics, foreign investments acquire special importance.

Despite the relatively high rate of the Kaliningrad region's economy and the positive dynamics of investments, the level of foreign investors activities is obviously inadequate to the Kaliningrad Region development interests. In this context, the search of ways to settle the problems, encumbering expansion of foreign investments in the region's economy, have become a priority. Even though Russian and foreign investors are similar in many respects, some of them are of a specific nature, given the conditions for activities of foreign companies in Russia. The special features are:

- higher sensitivity of foreign companies to worsening of economic and legal conditions for economic activities;
- unsurmountability of many administrative barriers, usual for domestic enterprises, for foreign investors;
- a lack of information about most Russian markets; underdeveloped infrastructure for support to business on the regional level.

On this background, it is extremely important that the Federal legislation – followed by the regional legislation – have not created equal opportunities for Russian and foreign investors and do not make any difference between them, thereby neglecting the need to create special incentives, to improve the region's attractiveness, and encourage foreign investments. Such approach is customary and comprehensible to European and probably to other Russian regions, however, taking into consideration the “non-standard” objectives, facing Kaliningrad economy, it cannot be laid in the foundation of regional investment policy.

Many studies were dedicated to exploration and solution of investors' problems in Russia during the recent years. The goal of our work is not a revision of the previous studies, but an analysis of changes to the conditions for foreign investors' activities in the Kaliningrad Region, which have taken place in the recent times. In this work, the authors make an attempt to reveal the main trends in the development of foreign investments, to identify the ‘bottlenecks’ and key problems (both those remaining from the past and newly emerging) relating to the activities of foreign investors in the territory of the Kaliningrad Region. On this basis, proposals are made on the ways to overcome the problems and the forms of assistance to the process of intensification of investment activities, which the EUROPEAID Project and the Regional Economic Development Agency (RDA) in the Kaliningrad Region could provide.

This Bulletin is prepared by the experts of the European Commission Project EUROPEAID/114287/C/SV/RU “Support for Regional Development of Kaliningrad” and of the RDA: M. Belonogova, A. Vialkin, A. Yershov, S. Klessova, A. Usanov, and A. Kharin.

1. Foreign investors' activities in the Kaliningrad Region

1.1. General characteristics of foreign investments

The activities of foreign investors in the territory of the Kaliningrad Region have a relatively long history. The first large foreign investments started arriving in the region as early as in 1992. Since then, foreign investments in Kaliningrad economy became an object of continuous attention of both representatives of State authorities and numerous independent observers.

The investments from abroad come to the Kaliningrad Region extremely irregularly. Some years, their volume increased or decreased three or more times (see Fig. 1). Some certainty settled only during the last 5 years, but even during that period, the inflow of foreign capital in Kaliningrad economy was characteristic of leaps and drops.

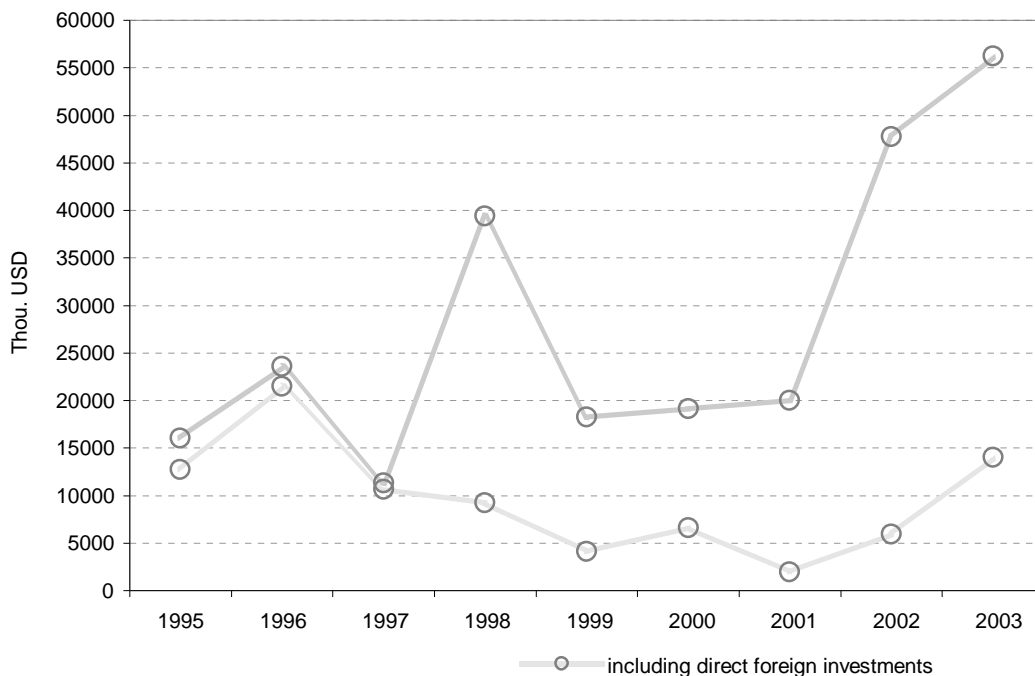


Fig. 1 Dynamics of foreign investments in the Kaliningrad Region during the period of 1995 to 2003, in thousand US dollars

Source: Kaliningrad Regional Committee of Statistics

In our opinion, there are several reasons for the instability of the inflow of investments in the region. First of all, it is the strong dependence of the regional economy on the state of affairs in the Russian economy. Practically, all the projects implemented in the region with the participation of foreign capital, are oriented to the Russian markets, and even minor negative changes in the sales opportunities inevitably lead to cutting back foreign investors' plans. This is supplemented with the established structure of foreign investments, mostly based on quick investments (goods, or short credits mainly aimed at servicing current foreign-trade transactions).

Another reason of the fluctuations is the permanent instability of the Special Economic Zone (SEZ) regulations, from the day of its establishment to this day. Because the SEZ customs privileges are one of the few arguments in favour of placing investments in the Kaliningrad Region, and for lack of other really considerable competitive advantages, any threat of their cancellation seriously affects the region's attractiveness for foreign investors. In particular, the 3-fold drop of the inflow of direct foreign investments in the year 2001 is mainly explained by the customs collisions, which took place in the beginning of that year.

Significant fluctuations of the inflow of foreign investments are also predetermined by the limited capacity of the regional investment market. For this reason, implementation of one or two relatively

large investment projects in the territory of the region substantially changes both the dynamics and the structure of foreign investments. .

Until recently, foreign investments did not play any significant role in the investment activities in the territory of the Kaliningrad Region. In 1995-2001, the average annual share of direct investments in the gross volume investments in fixed assets did not reach 10%, and only last year the proportion exceeded 15% of the total volume of capital vested in the non-financial economic sector in the region for the first time¹. However, given that this indicator in Lithuania, Latvia, and Estonia is 20-25%, one can make the conclusion that direct foreign investments (DFI), still play a modest role in the process of capital buildup. Even despite the record rates of the inflow of investments in the last two years, their volumes are evidently too low, compared with internal investments.

In the beginning of the year 2003, the accumulated volume of foreign investments made up 85,986 thou. USD, including 41,671 thou. USD of direct investments, 639 thou. USD of portfolio investments, and 43,677 thou. USD of other investments². Even though rather high accretion of foreign investments in the recent years, the region is still behind many Russian regions in this respect. Thus, in the beginning of last year the region's share in the total volume of foreign investments accumulated by Russian regions in the recent several years was under 0.04%, while the share of the region in the national GDP in the same period was about 0.5% and its share of the industrial output was nearly 0.4%. The region is listed 32^d -34th among the Russian regions by the volume of investments and occupies one of the last places among the regions of the North-Western Federal Area³.

An important indicator of significance of foreign investments from the point of view of their contribution to the regional development is the distribution by the nature of participation in the investment process. The established structure of foreign investments in the Kaliningrad Region is not optimal from the point of view of their contribution to the development of the regional industrial potential. According to the statistical data, a half of the investments 'accumulated' are represented by trading capital (trade credits, etc.). As a rule, such investments are directed to short-term quick assets and they are characteristic of a high rate of withdrawal (for example, in 2003, 67% of the volume of "other investments" in the region were withdrawn). Chiefly servicing trading transactions, this kind of investments practically does not contribute to the modernisation and development of the regional economy. The total share of all kinds of direct investments is 48% of the accumulated foreign investments. (see Fig. 2). The dynamics of this indicator do not inspire optimism either. Beginning with the mid-nineties, a steady decline of the weight of direct investments was observed, and in the last 3 years their average share did not exceed 1/5 of annual foreign investments (cf. 25% in 2003).

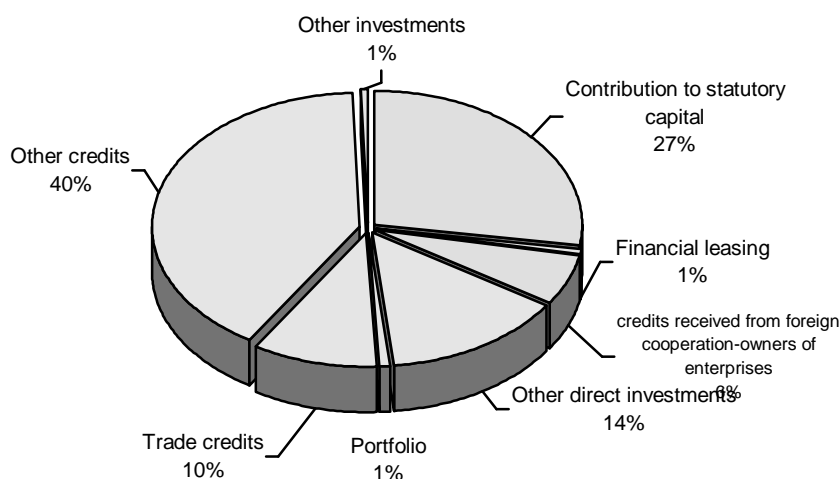


Fig. 2. Structure of foreign investments accumulated by the beginning of the year 2003 in the non-financial sector of the Kaliningrad Region economy

Source: Kaliningrad Regional Committee of Statistics

¹ Recalculated, based on the average-weighted USD exchange rate in that year.

² If not otherwise specified, hereinafter the data is based on the Statistical Collection "Investments in the Kaliningrad Region from foreign countries and investments from Kaliningrad region in other countries in year 2003". – Kaliningrad city, Kaliningrad Regional Committee of Statistics, 2004.

³ Source: <http://www.economy.gov.ru/merit/reginvest>

A special feature of the Kaliningrad economy is an extremely low specific weight of foreign portfolio investments. While their average share in the Russian Federation was 27% of all foreign investments, in Kaliningrad region the figure was slightly above 1% (in the whole year 2003, the amount of investments in shares and other securities of Kaliningrad enterprises made up only 0.5 thou. USD. This shows how underdeveloped the regional stock market is, and still a low investment attractiveness of the securities emitted by Kaliningrad enterprises.

1.2. Geography of foreign investments

The largest investors in the Kaliningrad Region's economy are Cyprus, Lithuania, Germany, and Great Britain. In the beginning of the year 2003, their share in the amount of accumulated investments was over 67%. The share of 7 leading investor-countries adds up to about 84% of foreign investments in the region (see Fig. 3). The remaining 16% belonged to 39 countries. The shares of fourteen of them in the accumulated investments did not reach 100 thou. USD. In 2003, the investments amounting to over \$2 million arrived from seven countries, and the threshold \$5 million was exceeded only by two countries (Cyprus and Germany).

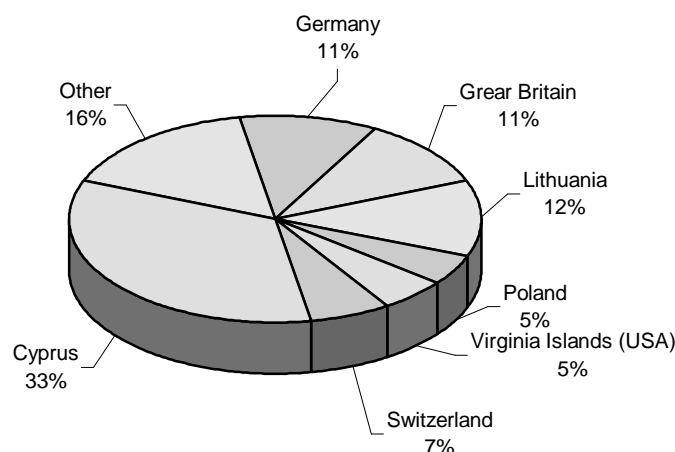


Fig. 3. Main investor-countries in the Kaliningrad Region (accumulated investments in the beginning of 2003)

Source: Kaliningrad Regional Committee of Statistics

The list of the main donor countries in the Kaliningrad Region is unstable. Thus, in the recent years, the activities of investors from Lithuania⁴, Great Britain, and Austria reduced. Since 1998, actually no investments were made by investors from Sweden and other Scandinavian countries – traditional investors in Baltic countries. At the same time, in 2002-2003, Cyprus became the largest investor in Kaliningrad economy: its share in these 2 years was nearly 60% of all foreign investments. Germany and Switzerland remain in the list of leading investors. The contributions of these countries are stable and made up about 1/5 of all foreign investments in recent years (see Fig. 4).

⁴ It should be noted that the statistical data for the year 2003 do not include one of the largest investment projects in the recent years, implemented with the participation of Lithuanian capital – the construction of a factory for manufacture of household refrigerators. The factory was put into operation in the beginning of 2004.

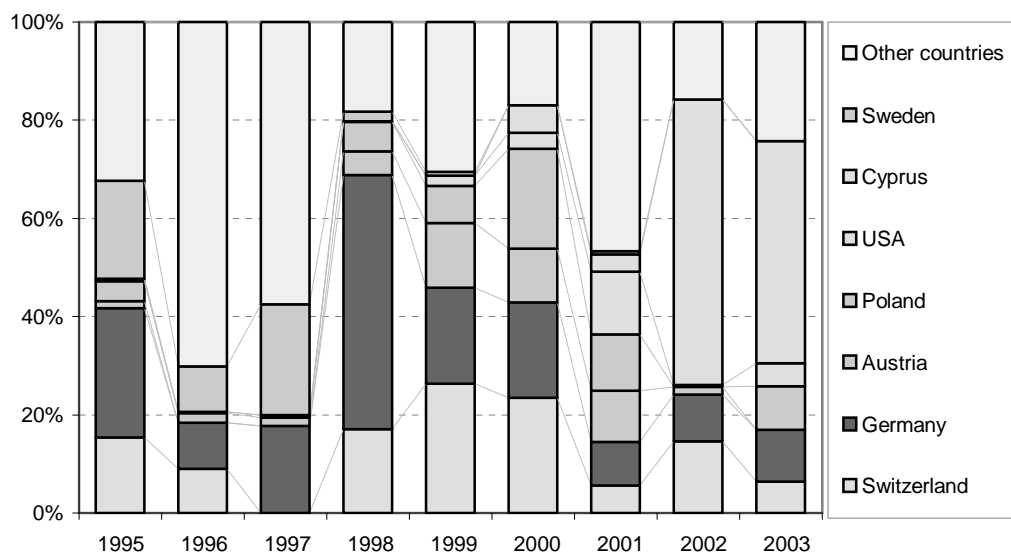


Fig. 4 Arrivals of foreign investments in 1995-2003 by main investor countries

Source: Kaliningrad Regional Committee of Statistics

Until now, no significant activity is demonstrated on the part of investors from the CIS countries. Thus, in the beginning of the year 2003, the amount of accumulated investments from Belarus' was under 4 thou. USD, and from Ukraine 23 thou. USD. On the one hand, this corresponds to the level of current economic relations between Kaliningrad region and those countries (it should be recognized that the Kaliningrad Region is not one of their investment priorities). On the other hand, this reflects the circumstance that investments from CIS countries in the territory of Russia are mostly implemented under the auspices of national capital.

A certain degree of specialisation has set up among the investor countries. Thus, the prevailing kinds of investments from off-shore countries and territories (such as Cyprus, Virgin Islands, Seychelles, Caiman Islands, the Isle of Man, Malta) as well as Poland and Great Britain are direct investments and long-term credits. Meanwhile, investors from the USA, Switzerland, and Belgium prefer investing in the form of trade and short-term credits: zero total annual balance of arrivals and withdrawals of investments is characteristic of these countries.. Enterprises from Lithuania, Germany, and a number of other countries are more inclined to maintain a policy of diversification of their investment portfolios⁵.

⁵ The data of this observation are conventional in many respects. They reflect the activities of foreign investors in 2003, but it should be understood that the implementation of even one relatively large project, involving arrival or withdrawal of foreign investments, can completely change the situation.

1.3. Investment attractiveness of economic sectors in the Kaliningrad Region

The nature of distribution of investments in this or another sector allows assessing the degree of the sectors' attractiveness for foreign investments, and, indirectly, the real competitiveness of Kaliningrad economic sectors. It is necessary to note that the assessment below is not an exhaustive characteristic of the sectors' attractiveness for investments. This is rather a complicated task, which should be fulfilled based on serious methodological support and lean on other than official sources of statistics. Our assessment allows making only preliminary, the most general conclusions about real preferences of foreign investors and some trends in their behavior during the recent years. It serves better understanding of the processes, taking place in the regional economic development, and of the role, played in it by foreign investors.

During the last 6 years, more than 60 organisations of different regional economic sectors were recipients of foreign capital. The data on the aggregate sectoral structure of foreign investments during the period of 1998 – 2003 are shown in Fig. 5.

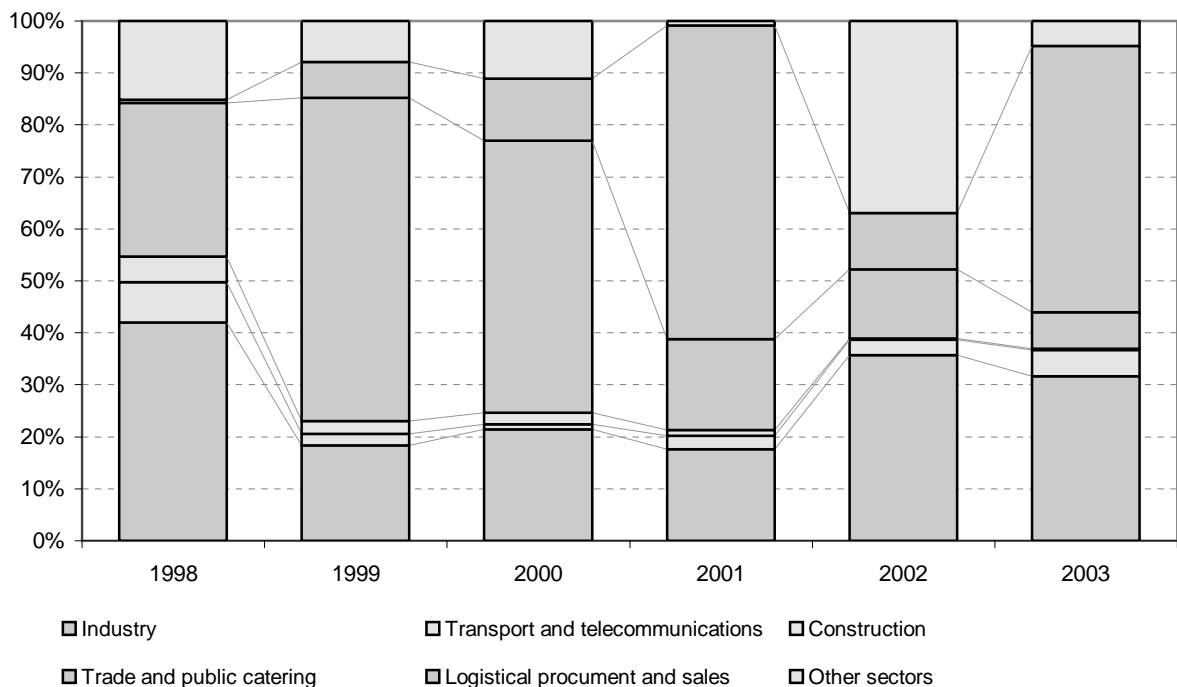


Fig . 5. Distribution of foreign investments by economic sectors in 1998-2003, per cent of total.

Source: Kaliningrad Regional Committee of Statistics

The diagram testifies to the above conclusion, that, due to the small total volume of foreign investments in the Kaliningrad Region, the implementation of even one large project results in significant changes in the sectoral structure of foreign investments. However, in spite of the remark, as time goes on, an obvious shift of sectoral priorities with regard to foreign investments in the regional economy is taking place. So, if, in the mid-90s, the most attractive for foreign capital were manufacturing industries, trade, transport and telecommunications, the total share of which was over 85% of the total volume of foreign investments arrived in the region, today, the leaders are logistical procurement and sales (42% of foreign investments in the last 3 years), industry (41%), trade and public catering (about 15%). The investments in construction have practically ceased, foreign investments in the transport sector, which is considered to be one of the priorities of the regional economy, have significantly decreased.

The main volume of accumulated investments is concentrated in the industrial sectors. The absolute leader among them is the fuels sector, where over 58% of the accumulated foreign investments are concentrated (93% of investments arrived in this sector in 2002, 61% of all foreign investments in Kaliningrad industries in 2003). In the territory of the region the fuels sector is mainly represented by oil-producing enterprises, which accumulate practically investment flows in this sector. The favourable

market conditions, good oil-extraction and transportation conditions, and the high quality of Kaliningrad oil make this industry especially attractive for foreign investors.

In addition to the oil sector, in 2003, foreign investors were active in the spheres of machine-building and metal-working. It was remarkable that while the main flow of investment resources were directed to the metal-working enterprises (23% of investment from abroad in the industries in the Kaliningrad Region), the largest volume of accumulated foreign investments were still in the machine-building industry (about 3% of all investments in industries). Over 2/3 of foreign investments in this sector are made in the form of capital investments (for the purchase of machines, equipment, stock, and tools).

The two industrial sectors (oil extraction and metal-working) added up are undisputable priorities for foreign investors in recent years. They have attracted the lion's share of foreign investments in the industrial regional industries. The share of all other industrial sectors is slightly more than 15%.

In the beginning of the year 2003, the wood-pulp and paper industry still held the second place among the regional industries by the volume of accumulated foreign investments (23% of the total amount of accumulated foreign investments in industries). But no foreign investments were made in this sector according to the statistical records in 2002-2003, although they usually were up to 1/5 of all foreign investments in industries in previous years. This circumstance could be explained by the extremely changeable conditions on the world wood-pulp and paper market. At the same time, there are signs that foreign investors do not take the risk of investing in the wood-pulp and paper enterprises in the region that are not highly prospective, technically obsolete, worn out, and at the same time capital-intensive. Facts show that this industry has actually lost its attractiveness for foreign investors.

The food industry, formerly rather attractive for investors, is progressively losing its positions. In 2003, the investments in this industry hardly reached 2% of all foreign investments in the regional industries, and the withdrawals were 1.5 times larger than investments. At the same time, this industry still remains one of the main directions of domestic capital investments, though with a lower volume than during previous years.

Positive changes have been noticed in the light industry, where foreign investments remain small, even though they have grown up 7-fold compared with previous years. The implementation of a number of small projects has been started, based on the use of such real competitive advantages of the region as relatively cheap labour and energy, favourable transport, and geographic position. In addition, the production of most light-industry enterprises is export-oriented. In this case, the effects of foreign investments are not limited to providing financial resources, but also include the transfer of technologies and commercial experience, and, above all, lead to involvement of Russian enterprises in the system of production/cooperation relations with foreign partners, and become catalysts for creation of an essentially new, fairly competitive branch of industry, blended in the process of international labour division. In recent years, the main objects of foreign investments in this sector are tailoring-industry enterprises.

The agriculture in the region appears to be quite unattractive in the opinion of foreign investors. Despite loud (but, probably, groundless) statements made by some Russian investors about the launching of a number of large agricultural projects, foreign investors still abstain from making any significant investments in this sector. The principal cause of investment unattractiveness of the Kaliningrad agriculture, in our opinion, is the non-competitiveness of local products, compared with cheap, subsidized imports.

According to the statistics, in 2003, only 45 thou. USD arrived in the agricultural production enterprises, and the sum of accumulated foreign investments - by the beginning of last year - made up 1,106 thou. USD. Practically all foreign investments are directed to the livestock farming sector.

Despite the unfavourable trends, characteristic of the past years, the transport sector continues to remain one of the basic directions of foreign investments in the regional economy. A special feature of this sector is that practically all accumulated foreign capital is concentrated in the enterprises which are carrying out cargo handling and forwarding activities. For different reasons, other directions of transport activities appear to be outside foreign investors' interests.

The years 2002-2003 are marked not only by a decline of investment activity, but are also connected to an intensification of the process of withdrawal of foreign capital from the transport sector. So, if in 2003 the inflow of foreign investments to this sector made up 1,759 thousand dollars, the volume of

their withdrawal exceeded 3,395 thou. dollars, and the process basically concerns withdrawal of direct investments – the previously made investments in the authorized capitals of transport organisations in the form of material or intangible assets.

On the background of the growth of domestic investments in the enterprises and the transport complex projects, the obvious drop of interest of foreign investors to this branch demands additional examination. Probably, this is a sign of reduction of investment attractiveness of the transport complex in the region, hidden behind apparent well-being (partly due to the effects of the large-scale budgetary infusions, which deformed and leveled market signals).

In many respects, the situation is the same in the telecommunications sector, where the volume of capital withdrawals in 2003 was 1.3 times above the arrivals of foreign investment funds.

Another significant change in the investment market conditions is the decrease of foreign investors' interest in the sphere of trade and public catering. Only 7.3% of the total amount of investments was directed to this sector in 2003, while up to the year 2000 this sector used to accumulate nearly a half of investments arriving from other countries. The high rate of capital withdrawals (in 2003, the amount of withdrawals was twice larger than investments) is connected with the fact that the prevailing part of foreign investments in this sector consists in trade credits (77% of the arrivals and 61% of the withdrawals in 2003).

In contrast with most other developments, noted above, the evident trend of reduction of the inflow and growth of the outflow of foreign capital in the sphere of trade and public catering has had a steady character (at least, during three last years). Together with the considerable decline of activities of domestic investors in this sector, this observation can indicate an occurrence of new tendencies in the development of the regional economy.

The investments in the resort/recreational complex, traditionally belonging to the regional development priorities, remain extremely inadequate. So, by the beginning of 2003, the total amount of accumulated foreign investments in the accommodation, recreation, and tourism facilities made only 13.4 thou. dollars, and the size of all investments arrived last year in the branches of the resort/recreational complex did not exceed 60 thou. dollars. The reasons of such passive attitude of foreign investors to this potentially profitable direction of entrepreneurship also require additional research.

The fast growth of foreign investments, for some years observed in the sphere of logistical procurement and sales, does not have a steady character and probably was mainly connected with the implementation of individual relatively large projects. Such conclusion is confirmed by the small amount of foreign investments accumulated in this sector (about 9% in the beginning of the year 2003). It should also be understood that this sector is an auxiliary part of regional economy. It is unable to become neither the centre of its long-term development, nor a reliable support to the growth of other sectors. The high specific weight of this sector in the total volume of foreign investments testifies to their non-optimal distribution in the Kaliningrad Region.

1.4. Investment attractiveness of municipalities

According to the data from the Kaliningrad Regional Committee of Statistics for the year 2003, 14 of the 20 territorial recipients of foreign investments are Kaliningrad Region municipalities. The data about the volumes of accumulated foreign investments by territories are shown in Fig. 6.

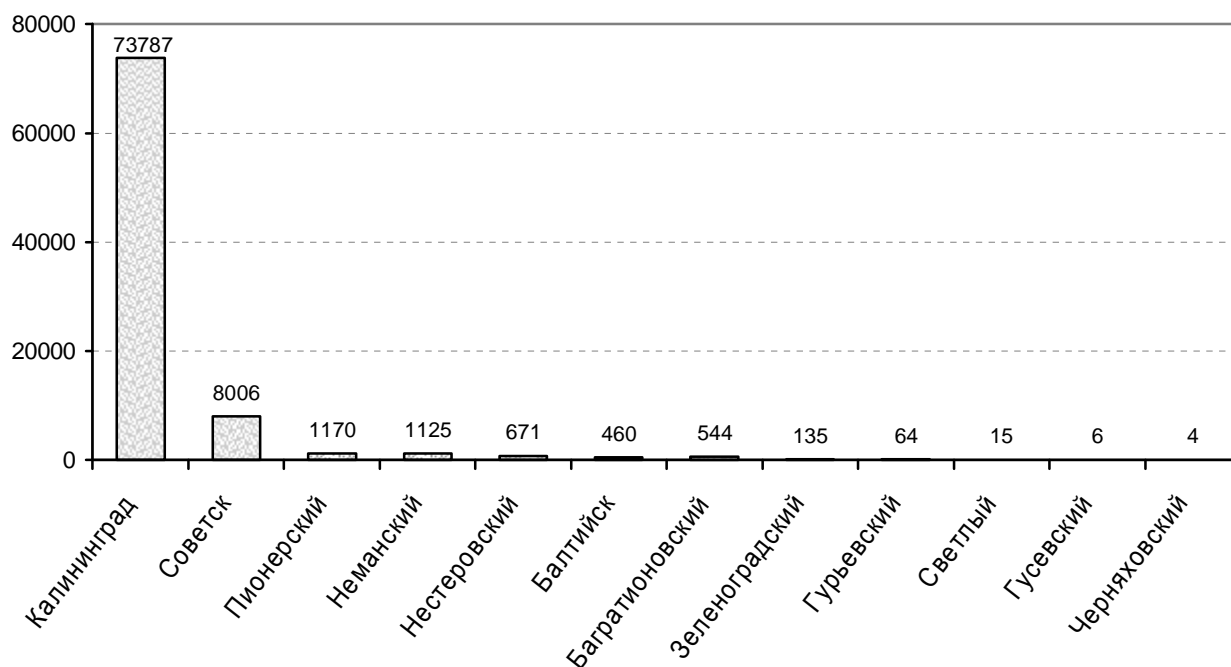


Fig. 6. Foreign investments accumulated in the municipalities of the Kaliningrad Region in the beginning of the year 2003, thousand USD⁶

Source: Kaliningrad Regional Committee of Statistics

The main part of foreign investments arrives in Kaliningrad city – the principal business, industrial, and commercial centre of the region, and its transport hub. The amount of foreign investments accumulated in this city considerably exceeds those in all other municipalities together (over 85%). Among the most attractive districts for foreign investors in the are the border territories with good transport links with neighboring countries: Sovietsk city (9.3% of foreign investments accumulated by the beginning of 2003), Neman District (1.3%), Nesterov District (0.8%), and Bagrationovsk District (0.6%). In 2003, major foreign investments were made in the territory of the Baltiysk Urban Area (1,900 thou. USD), and Pionerski town (15,315 thou. USD), which certainly will put the municipalities in the leading places.

It is necessary to note the low interest of foreign investors in such traditionally industrial centres in the region as Cherniahovsk, Gusev, Svetliy, among which Sovietsk city also appeared in 2003. Last year, practically no foreign investments arrived to these cities. Kaliningrad satellite cities Gurievsk and Gvardeysk are not attractive for foreign investors, either.

Externally safe from the point of view of investment attractiveness of Kaliningrad city as well as the region as a whole, has not an optimum structure of foreign capital participation in the investment process. A significant part of foreign partners' investments in the city enterprises is trading credits and other kinds of loans (over 62 %). A direct consequence of this is the low level of accumulation of foreign capital. In 2003, the volume of arrival of foreign investments in Kaliningrad enterprises was only 15 % above the volume of capital withdrawals.

1.5. Technological structure of foreign investments

One of the primary goals of attraction of investments (both foreign, and domestic) into the region is their assistance to modernization of the economy. The rate of accumulation of investments serves as an indicator, allowing to estimate the success of accomplishment of this task. Despite a certain growth of investments into the Kaliningrad region's economy, observed in the last years, the accumulation rate (the relation of total investments and gross regional product) is insufficient (in the Kaliningrad Region: 20%, in all Russia: about 30%). The share of direct foreign investments in the

⁶ In two municipalities – Gvardeyski and Slavski Districts – the amounts of investments were below \$1,000.

total accumulation of fixed assets does not exceed 3-5% (for comparison: in Poland this parameter is equal 23 %)⁷.

The established technological structure of foreign investments does not contribute much to the process of qualitative renovation of the regional economy. According to the statistics, the main foreign investments are directed to the sphere of logistical procurement and sales (78% of the foreign investments in fixed assets in 2003), and the share of all other industries is about 16%. In particular, all investments in the production industries were directed to machine-building and metal-working enterprises. Nearly 5% of the foreign capital was vested in the telecommunications sector. All other branches together received slightly more than 1% of foreign investments in fixed capital.

The investor State, which supports the process of Kaliningrad modernisation in the most active way, is Cyprus⁸. In 2003, its investments in the region exceeded 70%. The second largest investor in the region is Poland (about 9.5%).

The prevailing direction of foreign investments in Kaliningrad enterprises' fixed assets is investments in procurement of vehicles, equipment, and tools. The share of this group of items is about 98% of foreign investments in fixed assets. In 2003, foreign investors did not spend their funds on purchasing land plots and real-estate objects.

Despite the fact that some improvements could be observed in the technological structure of foreign investments, given the technical obsolescence and high degree of wear of the equipment in most enterprises in the region, the minor positive changes are still unable to ensure radical improvement of the regional economic competitiveness.

1.6. Major investment projects under implementation in the territory of the Kaliningrad Region with the participation of foreign investors

In the beginning of the year 2004, several scores of investment projects were under implementation with the participation of foreign capital. The largest of them – by the volume of investments – are as follows:

- "Construction of a tin-plate can factory in Kaliningrad city", project initiator: "Metal Package, Ltd.", investment volume on 1.03.2004: 1,594 thou. USD⁹, origin of capital: Cyprus;
- "Construction of a refrigerating terminal", "Greenterminal, Ltd.", 1154 thou. USD, Norway;
- "Construction of a secondary wine-making plant", "LB Ikalto, Ltd.", 89.3 mill. rubles, Lithuania;
- "Construction of meat-processing plant", "Kaliningrad Delicacy, Ltd.", 4,111 thou. USD, Lithuania;
- "Rehabilitation of the production areas of the refrigerator factory", "TechnoInvest, Ltd.", 13,700 thou. USD, Lithuania.

1.7. Foreign investments : hopes and reality

The specific position of the Kaliningrad Region as the western-most region of Russia, closest to major European markets, was always considered as an important advantage for attracting foreign companies in the region. The creation of the Free Economic zone "Yantar" (Amber)", followed by the establishment of a Special Economic Zone (SEZ), was justified by the need to attract foreign investments in the region.

Until 1991, the Kaliningrad Region was a territory closed to foreign nationals. For this reason, its opening and the creation of the SEZ "Yantar" in its territory in the same year resulted in a surge of interest to the region on the part of both large, medium-size and small foreign companies in the neighbouring countries. The most known investments in early 90s was the establishment of a joint venture with France Telecom, aimed at developing the wire telephone network in Kaliningrad city, the purchase of the "Avtogen" factory by the Swedish AGA AB company in 1992 (the factory had been

⁷ «Expert» No. 9, 8-14 March 2004, page 49.

⁸ This obviously concerns Russian rather than foreign investors.

⁹ This is data on volumes of the investments, declared by investors in the design and budget documentation, business - plans, presentation materials, etc. They might not coincide for the different reasons with the data of the State statistics and the fact sheets.

founded by the Swedish company in Koenigsberg back in 1917), the purchase of “BaltCran” package company’s shares by a German firm Noell; creation of plenty of joint ventures in the food industry by Polish companies, etc. In 1995, the number of enterprises with foreign investments exceeded 800, and the Kaliningrad Region was listed as one of the leading Russian regions in terms of the number of investments..

However the foreign investors’ optimism was soon dissipated. The SEZ legal regulations in Kaliningrad remained very unstable under almost yearly attacks on the part of the federal authorities. The region’s geographical position turned out to be not so advantageous because the transit through Lithuania and the need of passing customs procedures were leading to a substantial increase of the transportation costs and freight delivery delays. The general economic situation characteristic of a high inflation rate, the drop of the population’s incomes, the high unemployment rate, the specific features of doing business in Russia, and the infractions of law and business etiquette became a widely spread phenomenon, nor did it create incentives for foreign investments. In 1996, the Governor’s office was taken by L. Gorbenko, who did not readily welcome foreign companies. This even more abated the region’s attractiveness for foreign investments. Then the 1998 crisis occurred with an actual default of the Regional Administration to settle the Dresdner Bank credit. All this resulted in the drop of direct foreign investments to the lowest level since early 90s.

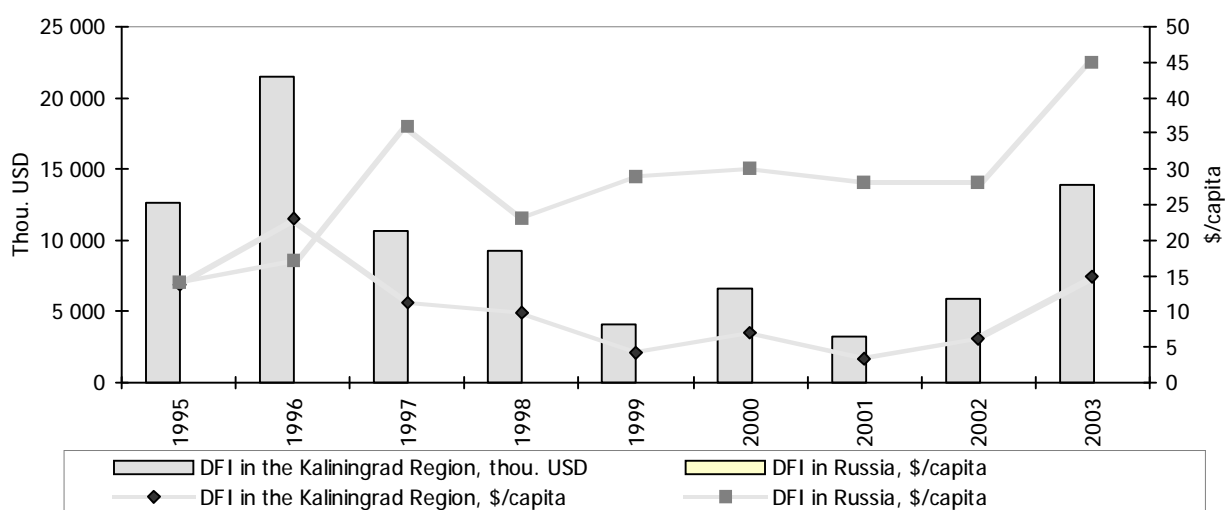


Fig. 7. Direct foreign investments (DFI) in the Kaliningrad Region and in Russia

Source: Kaliningrad Regional Committee of Statistics

A new wave of direct investments started since the year 2001. This was mainly caused by the improvement of the general economic situation in Russia and in the Kaliningrad Region, in particular, and the enhanced attention to the region on the part of the federal authorities and mass media.

Nevertheless, by the volumes of investments in the Kaliningrad Region is significantly behind the average Russian level, and the levels in the neighbouring countries Poland and Lithuania. In the beginning of the year 2003, the amount of accumulated direct foreign investments per capita in the Kaliningrad Region was \$44, while in Lithuania it was \$1,230. Despite the high rates of growth of foreign investments during the last 3 years, the region has not reached even its own maximum level of 1995-1996.

The enterprises with foreign investments are on average much larger, than Russian companies: each of them employs twice more workers, than an average Russian enterprise. In addition, foreign companies are more generous to workers, than Russian companies, and they invest much more intensively – despite their insignificant specific weight, in 2003, their share in the total amount of investments into fixed capital reached 16 %.

Table 1

Main performance indicators of enterprises with participation of foreign capital,
mill. rubles

	1999	2000	2001	2002
Number of acting enterprises	325	336	333	374
<i>Share of the number of organisations</i>	1%	1%	1%	1%
Output of products or services	2670	4180	5654	7833
Staff, thou. persons	7.6	8.6	11.6	16.1
<i>Share of the total number of employees</i>	2%	2%	3%	4%
Labour payment costs	170.7	324.8	561.1	971.9
<i>Share of the total amount of labour costs</i>	3%	5%	6%	7%
Investment in fixed assets	145.5	381.5	316.7	1039.2
<i>Share of the total amount of investments</i>	6%	8%	6%	16%

Source: Kaliningrad Regional Committee of Statistics

In many respects the sad experience of the first investors in the region makes foreign companies think, first of all, about decreasing the risks in planning their activity in region. Therefore, at present, foreign industrial companies try to limit their presence in the region and to operate in alliance with a Russian partner. Russian partners frequently charge themselves with investments into production capacities, relations with authorities, obtaining licenses and certificates, while western companies provide product components, accessories, assistance in selling the produce and render technical support to the organisation of the production processes. In this way the Russian company is using the SEZ benefits and can reduce the production costs, while the strategic marketing problems are settled by the foreign partner. As an example of such arrangement of interaction between Russian and foreign companies is the cooperation between "Avtotor" and BMW for implementation of the most known investment project in the Kaliningrad region – the BMW automobile assembly line. Such scheme is mostly popular with the machine-building, light and food industries.

The companies which invest directly in the region, usually already have operational experience in Russia or are well familiar with the situation in the region. Therefore the main foreign investors in the region are the companies of countries - neighbours of the Kaliningrad Region: Poland and Lithuania, and also Germany, that have historical connections with the region. The basic incentive for investments into the region are the SEZ privileges which allow foreign companies enter the large Russian market and to avoid payment of import duties.

At present, the influence of foreign companies remains insignificant: it primarily tells on the market of resources (labour, industrial premises). It occurs both by virtue of small volume of such investments, and owing to the use imported raw materials and manufacture components. The example of the "Food Stuffs" company is characteristic in this respect.

This firm was founded in 1994 by Croatian citizens and was dealing with import of chicken legs to Russia. In 1998, using their knowledge of the Russian market, the company started construction of a factory for production of frozen chicken semi-finished products and canned food under the "Golden Cockerel" trademark. The successful implementation of this project allowed the Food Stuffs to open the second stage of the factory in 2003 and to start the construction of the third stage, this time, for producing pel'menis (ravioli), and ready frozen lunches.

The company managed to involve investments of the European Reconstruction and Development Bank which received a 27.5%-share holding of the company. Altogether, from 1998 to 2003, the company invested approximately 36 million dollars. The production process is based on the use of imported chicken meat (from China and Brazil), therefore the influence of the enterprise on agricultural production in the region is insignificant. This example also illustrates the imperfection of the accounting of foreign investments. In spite of the fact that the Food Stuffs enterprise is the largest private recipient of investments from Croatia in Russia: Croatia is missing in the list of investor countries in the Kaliningrad Region.

1.8. Foreign investments in the Kaliningrad Region: comparison with Lithuania

The evaluation of activities of foreign investors in the Kaliningrad region would be incomplete without its comparison with the results in the adjacent territories, being to a certain degree competitors of the region in the struggle for attraction of foreign investments. The more so, because one of the main objectives of the investment policy declared in the Kaliningrad Region is catching-up with the levels of economic development in the adjacent countries.¹⁰ It is obvious, that comparison of the Kaliningrad region primarily with the economies of the Baltic area, whose sizes are comparable with that of the Kaliningrad Region is of the greatest interest, first of all, the comparison with Lithuania¹¹.

Let us note, that despite all the differences of the investment conditions and business opportunities for doing business, the distribution of foreign investments by branches of economy in the Kaliningrad region is in many respects similar to the situation in Lithuania. According to the statistical data provided by the Lithuanian Department of Statistics, the largest part of the accumulated direct foreign investments in Lithuania is concentrated: in the sphere of commercial and financial services (33%), in manufacturing industries (30%), and in the trading sector (19%). This approximately corresponds to the sectoral structure of the accumulated foreign investments in the Kaliningrad region and shows that, in general, in selecting sectoral investment priorities, foreign investors are inclined to be guided by similar approaches.

However the scale of foreign investors' activities by which Lithuania surpasses the Kaliningrad region by over 100-fold (on 01.10.2003, the volume of accumulated direct foreign investments in Lithuania made 3,852 million euro, and in the Kaliningrad region 40.7 million dollars).

The level of penetration of foreign capital in the economy is quite different. At present, such branches of the Lithuanian economy as power, fuels, textile, and food industries, telecommunications, and financial services are actually controlled by foreign investors.

The presence of foreign capital in the Kaliningrad region is not dominating in any branch. Moreover, by the geographical structure of investments into the regional economy, the so-called "foreign" capital, mostly has the Russian origin. However, unfortunately, based on the data provided by the State statistics, it appears impossible to separate the 'real' foreign investments from "imaginary" ones.

It is obvious, that despite the positive shifts that have recently occurred in the activities of foreign investors in the territory of the Kaliningrad Region, the conclusions made in the previous Tacis studies of the Kaliningrad are still valid: the absolute amount of arrivals of foreign investments in the region is small and obviously insufficient in comparison with the investment needs for the development of the Kaliningrad region. The reason of it lies in the remaining fundamental conditions of investment unattractiveness of the region which have been repeatedly mentioned in our reports, and by virtue of which the Kaliningrad region is not an advantageous object for accommodation of capital investments, both domestic, and foreign.

2. Regional investment policy problems

2.1. Foreign investments in Russian regions^ status and prospects

In September 2003, Russia became one of the ten countries that were the most attractive to foreign investments. Russia had made the most appreciable breakthrough: in 2002 it moved from the 32nd to the 17th place, and in 2003 to the 8th place. In October, 2003 the International rating agency Moody's lifted the ceiling of Russia's sovereign rating to Ba3 investment level (earlier Russia's speculative rating was Ba2). Simultaneously, the ruble bonds ratings were raised to the same level and the ratings of bank foreign currency deposits were raised to level Ba1 All the ratings are forecast to be stable. Thus the changes in the growth of investments in fixed capital considerably exceed the rates of growth of basic macroeconomic parameters.

In the end of June, 2003, the accumulated foreign capital in the economy of Russia made up 48.3 billion US dollars, which was 26.7 % above the level of the similar period of previous year. The greatest weights in the accumulated foreign capital fell to other investments: 50.9 % (in the end of June, 2002 it was 47.5 %), the share of direct investments: 46.7 % (48.7 %), portfolio investments:

¹⁰ Стратегия социально-экономического развития Калининградской области как региона сотрудничества на период до 2010 года

¹¹ See more details in Section 3 of this Bulletin

2.4 % (3.8 %). Thus, the down trend of weights of direct investments and the up trend of weights of other investments in the Russian economy prove to be true.

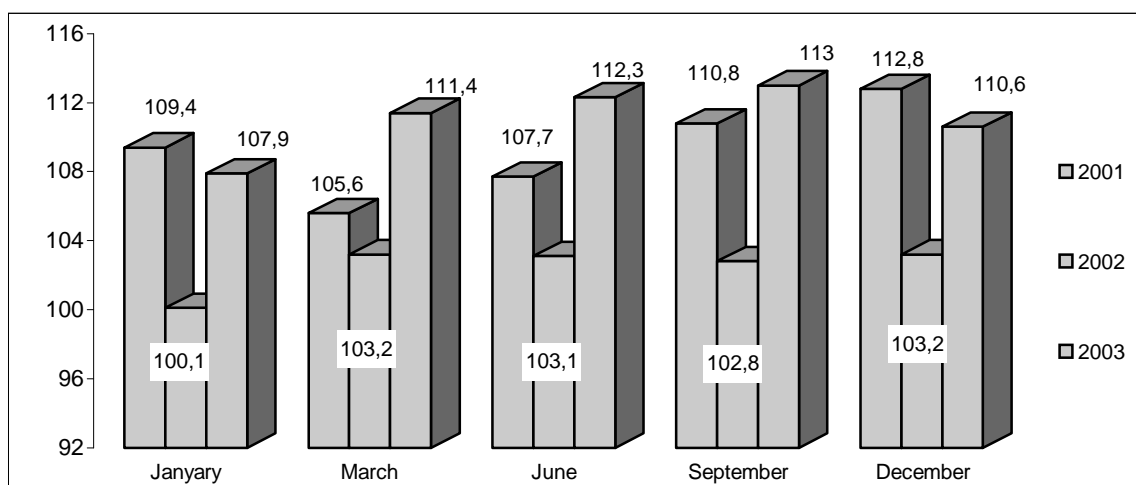


Fig. 8. Dynamics of investments in fixed capital, percentage of similar period of previous year

(Prepared based on the data from the RF Ministry of Economic Development and Trade and the Committee of Statistics of Russia)

The continuous up-trend of the investment activity growth in the Russian Federation (see Fig. 7) is explained by the objective and market conditions, established since the beginning of 2003, which had a positive effect on the investment dynamics. The factors listed below could be considered as the main factors that influence the investment activities on the national level as a whole:

- remaining high world prices of energy and metals, which contributes to the accumulation of assets in export-oriented branches and production sectors;
- increase of financial 'transparency' of Russian enterprises;
- growth of demand for domestic investment goods on the background of high prices of similar imported goods, which has found its reflection in the acceleration of the growth of mechanical engineering production;
- increase in investment resources of the population due to the growth of real available monetary incomes;
- active involvement of monetary resources in the investments due to the falling profitability of ruble financial tools which stimulates private investors to invest in real economic sectors;
- decrease of refinancing interest rates of the Bank of Russia;
- shaping of a positive investment image of the Russian Federation according to the international rating agency "Moody's Investors Service".

On the other hand, the major factors, still constraining the investment activity in Russia, are:

- the high dependence of the national economy, public finances and balance of payments on the external economic conjuncture, given the current structure of the GNP;
- excessive administrative barriers in the way of entrepreneurship activities;
- insufficient legal protection of domestic and foreign investors, weak legal practice;
- lack of effective mechanisms for stimulation of investment activity of the taxpayers, given the generally high tax burden on business;
- rather high price of commercial credits, despite the considerable reduction of the interest rates on the financial market;
- lack of effective mechanisms of transformation of savings of the population into investments;
- insufficient stock market development level.

2.2. Regional investment policy tools in the Russian Federation

The regulation of economic relations between the federal authorities and the regions is becoming one of the sharpest and important problems of the Russian economy. An important part of this problem consists in the imbalance of the relations on the issues relating to the support and stimulation of investments. For different reasons, being devoid of the opportunity to carry out an active investment policy on the regional level, RF subjects are, in many respects, compelled to copy the measures implemented by the federal authorities. Meanwhile, a number of RF subjects, primarily those having

adequate own resources, are trying to use all available possibilities and to concentrate on development of their own investment legislation. In particular, understanding that safety of invested capital is of prior concern to investors entering the regional market, a regulatory framework is set up in some regions for guaranteeing foreign capital, and credit guaranties corresponding to the world practice are introduced.

So, for example, in order to protect foreign investors' rights in Moscow, the authorities practice using municipal real-estate assets as pledges for business deals. It is considered, that public guaranties allow involving funds from the open market of resources in investment projects, without resorting to large-scale financing from the RF subjects' budgets.

As a guarantee of stability of land relations, the Government of Moscow also uses such a legal tool, as the right of long-term rent of the land plots. The possibility of using buildings and land plots, the right of disposal of which belongs to regional or municipal administrations (in a wider sense – the development level of the entire economic infrastructure) renders significant influence on the efficiency of private investments and consequently is one of determining conditions for attraction of foreign investors in the region. The Government of Moscow is also actively using a policy of encouragement of and support to foreign investments by providing various incentives, including city tax benefits and reduced charges.

The main forms of this type of support to investment activity in the territory of Moscow are:

1. Granting city tax privileges (in addition to federal tax benefits) for priority directions of urban development, for support of certain branches of economy, for implementation of investment projects, important for urban development, etc.
2. Deferment of payment of taxes to the city budget (up to 6 months) in order to direct the deferred tax payment funds to implementation of own investment programmes, accumulation of financial resources for procurement of raw material and the materials necessary for subsequent increase of manufacture and sale of products.
3. Establishment of territorial units with a special status where additional privileges and preferences are provided in the framework of the city authority, mainly concerning land and real estate rent payments as well as utility service tariffs.
4. Besides, the government of Moscow is actively using the opportunities stipulated by the RF Law of 10.02.1999 No. 32-FZ "On introduction of amendments to the legislative acts of the Russian Federation, ensuing from the Federal Law "On the Product-Sharing Agreements", according to which foreign investors receive concerning federal and regional taxes and charges, envisaging substitution of tax payments by dividing the manufactured products between the State and the investors.

It should be noted that tax privileges practically are the most widespread and effective ways of stimulation of investment in Russian practice. In most cases tax privileges include a temporary reduction or cancellation of the profit tax rate and of some other taxes, listed in the regional budget. The kinds of privileged taxes strongly vary in the sizes and duration of validity, depending on the region.

The support of investment activity by investing from the Russian regional budgets is less widespread in the practice of RF subjects – the legislation of some subjects provides a development budget system, similar to the Federal Development Budget. Some subjects of the Russian Federation carry out additional development of public investment programmes of the Russian Federation, develop the list of priority economic sectors and public-supported investment projects implemented in their frameworks.

Among other forms of support to investment activity in Russian regions, it is necessary to note the measures for creation of a system for informing potential investors, including foreign investors, about the regional policies towards attraction of investments. The participation of authorities in granting to investors the fullest possible information on the conditions for business activities, the condition of the economy and of the social sphere in the regions could become one of the factors of increase of their investment attractiveness.

The reserves for improvement of the investment climate of most regions are connected with reduction of investment risks and perfection of legislative base for investors' activity. The widespread phenomenon in the practice of support to and protection of investments are regional authorities'

guarantees in relation to investors, available in many RF subjects¹². Public guarantees, including legal, property, financial and other types of them, as a rule, are:

- ensuring equal rights in carrying out investment activities;
- transparency of discussion of investment projects;
- guarantees against illegal actions (inactions) of public authorities and the right to sue public authorities (local government authorities and their functionaries) for any decisions, actions and/or inactions;
- providing stability for investment activity subjects for a certain period, stipulated by the new legislative acts, in the cases when laws for investment activity subjects are adopted changing the rules, which were effective, when contracts were signed between the subjects;
- protection of investments (this means guarantees on compensation in the cases of nationalisation or confiscation of investments);
- investment insurance;
- guarantees on the use of incomes;
- guarantees on the use in the Russian Federation and transfer out of the Russian Federation of incomes, profit, and other amounts of money legally gained by foreign investors.

There are also other legislative acts of the Russian Federation stipulating additional guarantees for carrying out investment activities, aimed at reduction of risks for investors¹³.

At the same time, the key problem of regional development remains inadequate regulation of issues concerning delimitation of powers of federal authorities and regional administrations. The different levels of economic development of regions result in a difference in the autonomy of the regions established unilaterally or fixed through conclusion of special agreements. Such practice leads to frequent and unpredictable changes to the legislation, reduces the transparency of the law-enforcement system, increases the costs and instability. Therefore, at present, the key measures for coordination of federal and regional authorities' efforts are:

- countrywide introduction of a regional legislative stabilisation reservation – a guaranty to be granted to foreign investors;
- creation of an efficient system of guaranties and investment risk insurance on the regional and interregional levels;
- ensuring of stability of the system of regional guaranties and privileges.

Another important aspect of interaction should be the determination - by federal authorities - of general directions for attraction of investments: what regions and sectors are priorities from the point of view of attraction of direct foreign investments. Without such coordination the attraction of foreign investments will not be efficient and will only result in enticing investors from one region to another.

2.3. Main obstacles in the way of foreign investments in Russia

Foreign investors face plenty of obstacles in the Russian Federation. The reasons of the obstacles are primarily connected with the particularities of the Russian legislative system and the Russian administrative law enforcement practice. The main problems encumbering and complicating foreign investors' activities in Russia are outlined below.

2.3.1. Legal norms

a. Unexpected changes to the legal acts and the retrospective acts

New legal norms, no matter if they are laws or sub-laws, often are introduced not only without a preliminary open discussion, but even without necessary publication. That's why even specialists often cannot receive information about the changes to the legislation.

b. Insufficient conformity of some laws

¹² For example, the Law "About incentives for attraction of foreign investments in the Chita region" of 19.12.2001.

¹³ For example, the Directive of the Government of the Leningrad region of 17.09.2001 "On the procedure of granting public guaranties of the Leningrad region for investment-oriented loans" and the laws adopted by the St.-Petersburg Legislative Assembly: "On public support to investment activities in the territory of St.-Petersburg", which specify the tools used by the city to attract investments; "On introduction of supplements to St.-Petersburg law "On tax benefits", which stipulates the terms and the size of tax privileges granted to investors; "On investments in real estate in St.-Petersburg", which regulates the procedure of allocation of real estate, managed or owned by the city, to investors.

Alongside with the Constitution and Laws, there is a great number of sub-laws in the Russian legislation: decrees, directives, orders, instructions, letters, etc. The various legal norms, regulating the same legal relations, often contradict one another. In addition there is no clear hierarchy of the legal acts, of a mechanism specifying which of the legal numerous legal provisions on the same issue are to be applied in a concrete case.

c. Inadequate consideration of economic interests in the process of law-making

Many laws of the Russian Federation do not sufficiently reflect the economic/legal relations, which they are to regulate. Instead, they support only the interests of individual economic groups or regions.

2.3.2. Implementation of legal acts by Russian executive authorities

Not less, if not more, important than the availability of reliable legal provisions is the practice of application of legal norms. The administrative practice in the Russian Federation does not contribute to the establishment of cooperation, based on trust.

a. Non-observance of legal provisions and international agreements by administrative bodies

Often, Russian executive authorities' actions do not comply with the existing laws and international agreements, signed by the Russian Federation. In particular, this takes place when the subject of the laws or agreements is granting privileges to foreign investors. So, for example, the RF law "On foreign investments" envisages granting privileges to priority investment projects, which are to be included in the list, approved by the RF government. Up to now, neither such a list, nor the procedure of inclusion of certain investment projects in the list have been adopted.

b. Non-observance of the basic principles of commensurability of the executive bodies' actions

Russian administrative bodies often do not observe the principles, accepted in Western countries. In particular, the equality of all before the Law, the commensurability of all measures taken, and the ban on arbitrary actions. This especially concerns the sphere of activities of customs and taxation bodies. Frequently, the executive authorities justify their decisions by protection of an assumed priority of national interests.

c. Lack of coordination of different authorities' activities

Different interpretations of juridical definitions of the Law take place on the part of different administrative bodies, which is essential for certain specific cases. For example, administrative bodies in Russian regions interpret legal provisions otherwise than federal authorities. Regional authorities are often not informed about the legal trends, established on the federal level.

d. Lack of a mechanism for learning the official opinion of public bodies

The Russian legislation does not adequately ensure provision of clarifications of binding nature by the authorities. In the current legal situation, a foreign investor, relying on the information received from an official body, cannot be sure that the information will not be disregarded by another or even the same officials. At the same time, planning of the investment process in certain legal conditions is very important for a foreign investor.

2.3.3. Taxes and custom duties

One of the major obstacles in the investment practice is the Russian taxation and customs legislation, and the main barriers for foreign investors are the unsatisfactory mechanism of legal regulation and application of the essential rules by the Russian taxation and customs bodies. The imperfection of legal protection of investors is particularly manifest in the sphere of Russian tax and customs legislation. Especially notorious are the ungroundlessly high sanctions with no account of the real fault of the taxpayer – in particular, because, contrary to the provisions of the Tax Code, ambiguous cases are usually interpreted to the detriment of the taxpayer.

2.3.4. Obstacles in the way of investment activities concerning individual types of taxes

a. Lack of a tax deduction on the reinvested part of profit

After the adoption of the Second part of the Tax Code, investor-enterprises have lost a very substantial incentive, envisaging reduction of the taxable bases by the reinvested amount of the profit.

b. Restrictions concerning carry-forward

The fiscal bodies apply the carry-forward of losses only for Russian companies. They refuse to do it for foreign companies (production enterprises), despite the non-existence of adequate legal grounds for the refusal.

c. VAT offset

Contrary to the legal provisions, the offset of the VAT paid on suppliers' bills, is allowed only in cases, when in determining the taxable base, the payments of suppliers' bills are deduced as production costs. Foreign companies, which have their offices in the Russian Federation, are often charged with the Russian VAT, when they use Russian companies' services, because the place where the services are provided in most cases is Russia. The VAT offset procedure connected with exports of commodities is ungroundlessly complicated and time-consuming.

2.3.5. Currency regulation

Practically any investment activity of foreign persons in Russia and every commercial deal with a Russian partner involve a payment – “a currency operation”. In this connection it should be noted that currency legislation has actually largely lost its clarity because of the regulatory legislation by the Central Bank of Russia. Any, even the simplest export or import transaction is subject to numerous complicated provisions of currency legislation, which can be comprehensible only to specialists. Every export or import deal has to be supported with a “Transaction certificate”. The introduction of new, more advanced currency legislation has been protracted for several years.

2.3.6. Corporate law

a. Registration of legal persons

As a result of the unsatisfactory system of registration of legal persons in the Russian Federation, contracts are often recognized invalid by courts, because they were concluded by persons who had not been authorized to do so. A register, containing relevant information about the representative powers and supported with legal guaranties of their correctness, might substantially facilitate legal relations in Russia and with Russia.

b. Forms of legal persons

At present, most foreign investors chose to use for their investments the legal form of a joint-stock company (JSC) or a limited-liability company. However, the legal form of such types of legal entities rather encumbers than assists foreign investors' activities. The legal provisions for establishment of a JSC are mostly of a compulsory nature and thereby restrict the foreign investors' freedom of actions. Besides, the joint-stock company regulations contain long and detailed prescriptions, which unnecessarily complicate the internal procedures, such as calling and holding of the shareholders' general meetings. The procedure for increasing of the authorised capital is complicated and nearly incomprehensible.

c. Protection of minority in Russian companies

Foreign investors in Russian companies often face the need to chose whether to take the majority in the company or to refuse the investments altogether. In such cases, the possibility of participation in a company as a minority is simply not considered. One of the reasons of that are the precedents where the holders of the majority of shares unscrupulously abused the opportunities available to them because of their majority position in the company.

2.3.7. Bankruptcy of Russian enterprises and banks

By now, the main regulatory legal documents stipulating the bankruptcy procedure in Russia have been adopted. Despite the imperfection of some details, as a whole, the acts can be recognized. adequate. Nonetheless, the practice of treating bankruptcy cases is extremely unsatisfactory. The main shortcomings can be mentioned as follows:

a. Lack of legal consequences in cases where indebted enterprises illegally transfer their property elsewhere in order to avoid its eventual sale for satisfying their creditors' claims. In practice, the lack of prescriptions concerning the sanctions to be used in case of concrete procedural errors, has had negative effects. As a rule, according to the Russian legislation, legal procedures are executed in three or four instances. If the bankruptcy suit is contested, for some unclear reasons the bankruptcy case shall be handled by only one instance, which often is insufficient for proper examination of frequently complicated circumstances.

b. Securing of credits

There are very few possibilities for satisfying credit claims in the Russian Federation. The admissibility of the transfer of the right to property is doubtful. In principle, the reservation concerning the right to property in accordance with Article 451 of the Civil Code is possible, but difficult to implement in practice because of the weakness of the Russian judicial/executive system and penal legislation. According to the verdict of the RF Supreme Court, the cession of the pledge, which is probably the most important group of cases, – the cession of the right to pay from the debtor's bank savings – is inadmissible.

Especially problematic is the fact that according to the Russian legislation, in case where the debtor is declared insolvent, creditors' suits and claims are considered third-rate, i. e. after servicing the claims of the employees, etc. For example, if the asset, used as the pledge, is a valuable piece of real estate, the case might not reach the creditor's satisfaction stage, because the pledge will be used for satisfaction of the 1st and 2nd rate claims.

2.3.8. Other barriers to investments

a. Right to real estate

In legal transactions with all kinds of real estate (not only land plots and buildings) the problem also consists in the fact that the register of the rights to real estate and legal transactions therewith, created according to the new law on registration, does not enjoy public trust. This means, that the real-estate purchaser's trust in the correctness of the register is not protected. Therefore any buyer of real estate risks, that his transaction for the purchase of real estate can be declared void, because the person specified in the register as the owner, actually is not.

b. Certification

The law of the Russian Federation "On certification of products and services" pursues a positive purpose – to ensure that the quality of goods, sold in the Russian Federation, is not below the established minimum level. However the application of this law in practice results in the wide examination of all goods, which essentially complicates the commercial activities in Russia.

c. Special obstacles to banks' investment activities

The banking licensing procedures are extremely complicated. In particular, the following barriers should be noted:

- establishment of a bank requires a license from the Central bank;
- the managing personnel must have at least the Higher Banking Training grade, and their professional qualification must be supported with relevant certificates;
- the authorization of the managing personnel is controlled by the Central bank;
- detailed information must be submitted about all parent company's boards;
- the accountancy manager must be selected only from a certain pool of persons.

Another obstacle is that in addition to the staff directly involved in the banking activities, there must be special personnel for currency and general control operation. Besides, alongside the personnel for keeping the international balance there must be specialists for keeping Russian-standard accounting books.

2.4. Barriers to foreign investments in the Kaliningrad region

Foreign investment activity in the territory of the region is in many respects determined by the economic and legal conditions and tendencies, characteristic for this field of activity in Russia as a whole. This can be explained, as it has been noted above, by the stringent unification of all Russian legislation, regulating foreign investors' activity issues.

In recent years, in the framework of various projects, a number of studies were carried out for identification and analysis of the barriers in the way of foreign investors in Russia. The review of the studies results allows making the conclusion that the main reasons, restricting the activities in the region are of a combined nature and are only partially connected with economic and legal aspects.

Thus, according to the results of the studies carried out by the FIAS in the summer of 2002, the principal problems impeding the development of business and the inflow of foreign investments in the Kaliningrad Region are:

- the instability and complexity of the customs procedures, and the style of operation of Russian customs bodies, 'inconvenient' for business;
- 'the procedural burden', consisting in the complexity of the procedures, connected with the start-up of investment projects and obtaining of legal privileges and preferences; the protracted and non-transparent interaction of enterprises with the control/licensing bodies; the lack of coordination among the public authorities and the licensing organisations;
- the lack of attention on the part of functionaries to investors' problems; lack of their interest in providing support to business, sometimes taking a form of sabotage of the current legislation and disregard of previously made decisions.

Other most frequent reasons interfering with investments in the Kaliningrad region are:

- the lack of complete information about the investment environment in the territory, about the local legislation and general conditions for doing business;
- the inconsistency of regional and local authorities' actions, their neglect of the necessity to implement a long-term economic policy, aimed at ensuring achievement of the strategic goals of regional development;
- the underdevelopment of the regional infrastructure for provision of professional services to investors.

The proximate study carried out in the framework of the EuropeAid project has confirmed the assumption that the above barriers, still are the main brakes for foreign investors' activities in the territory of the Kaliningrad Region. This conclusion is, in particular, based on the results of a survey (carried out in the spring of 2004) of Lithuanian entrepreneurs, working in the Kaliningrad Region. The survey showed that the principal barriers to attraction of foreign investments in the region today are:

- the lack of real public guarantees for foreign investors, given the instability of the economic activities in the region (including the changeability of federal and regional legislation);
- the complex and contradictory nature of the system of legislative regulatory acts, which creates conditions for abuse on the part of functionaries in the control/licensing authorities;
- the lack of complete information about the conditions for operation on the local market, about potential partners in Kaliningrad and in other Russian regions.

The above critical investment barriers are of a general nature, but they are aggravated by some problems, specific for Kaliningrad, among which the Lithuanian businessmen mentioned:

- the shortage of skilled personnel capable of efficiently fulfilling complex technical tasks;
- the complex and multi-stage procedure of obtaining certificates about the SEZ origin of goods, the lack of alternatives in selecting relevant experts, and the monopolisation of this sphere of activity by one organisation;
- the lack of other than customs concessions (taking into account the uncertainty of their prospects) and incentives for investments in the region on the background of the actual liquidation of the system of regional privileges for investors. From the point of view of creation of favourable conditions for foreign investors, the Kaliningrad Region is not different or is worse than most other RF regions.

The main factor, determining foreign investor's preparedness to invest his/her capital in this or other sphere of activity in the Kaliningrad Region, is the investment environment in the region. It represents the combination of political, legal, economic, social, household, and other conditions, which finally determine the degree of investment risks and the efficiency of investments.

2.5. Investment legislation in the Kaliningrad Region

In shaping of a favorable investment climate in the region, the most important factor is legal stability. The stability of the legislative framework, the observance of legal norms, and ensuring their compulsory execution are the basic conditions, determining the region's attractiveness for foreign investors. Therefore, the objectivity and completeness of analysis of the problems, interfering with intensification of foreign investors' activities in the Kaliningrad region, largely depend on the assessment of the legislative framework allowing carrying out investment activity in the region.

The basis for foreign investors' activities in Russia is the federal law No. 160-FZ of 09.07.1999, amended by law No. 169-FZ of 08.12.2003. "About foreign investments in the Russian Federation".

According to the law, the RF subjects are entitled to develop regional investment policies and shape their own investment legislation. Opportunities are provided to the RF subjects to regulate the following rules for creating a favourable investment environment:

- temporary full or partial exemption from taxes to be paid to the RF subjects' budgets;
- deferral or spread of payment of taxes to regional budgets;
- granting of investment tax credits;
- granting of loans from the budget, soft loans (credits);
- provision of regional administration's guaranties to investors;
- placing of priority public (regional) orders with enterprises-recipients of investments;
- assistance for creation of business infrastructure, for renting and purchasing land plots and non-residential premises, belonging to the RF subjects' public property.

Regional legislation is a mirror-reflection of provisions of federal laws and may not contradict norms, established on the federal level. That is why, as it has been mentioned above, regional law-making is limited by the stringent frames of the general Russian laws and other regulatory acts. On the other hand, because federal laws often contradict one another and have an unstable basis, regional legislation is also contradictory and unstable. In addition, regional legislation contains shortcomings, superimposed, besides other reasons, by the lack of codification of regional laws. The above-mentioned problems in the way of attraction of investments are also characteristic of the Kaliningrad Region legislation.

The range of the legislative documents, regulating investment activity issues in the Kaliningrad Region is rather narrow and limited to laws and regulations of regional and municipal levels. Among the most important of them are the acts determining the main particularities of investors' activities in the region, namely:

- the Kaliningrad Region law "About public support to organisations, implementing capital investments in the territory of the Kaliningrad Region";
- the Kaliningrad Region law "About the procedure of granting tax concessions and privileges concerning payments to the regional budget";
- the Decision of the Kaliningrad City Council of Deputies "About the approval of "The provision on the procedure of granting tax concessions concerning payments to the city budget";
- the Decision of the Kaliningrad City Council of Deputies "About the approval of "The provision on regulation of capital investment activities in the territory of Kaliningrad".

Besides those acts, most of the municipalities have adopted their own provisions, regulating the investment support issues on the local level. The current legislation of the Kaliningrad Region lacks any regulations, specially dedicated to *foreign* investors' activities. That's why all aspects of foreign capital activities in the Kaliningrad Region are regulated by the federal and general regional legislation.

According to the above-mentioned documents, favourable investment environment in the region is facilitated by the following complex measures:

- granting tax benefits;
- free allocation of land property owned by the State or municipalities;
- granting investment allowances on the organisations' property tax with respect to amounts to be transferred to the local budget;
- subsidizing of a part of interests on credits;
- provision of credit resources to investors on returnable and paid basis, as well as public guaranties in pledge of return of the investment funds from the budget;
- support to priority investment projects.

Among the above regulatory acts the central place belongs to the Kaliningrad Region law No. 171 "About public support to organisations, implementing capital investments in the territory of the Kaliningrad Region". The said law stipulates the framework conditions and serves as the basis for development and implementation of State and municipal measures of support to investment activities in the region.

The basic contents of the law concern the system of tax benefits. According to this law, the investors meeting the requirements of the Law, are exempted from payment of the tax on the organisations' property, the land tax, the charge for using water bodies, and a part of the profit tax concerning the sums of the taxes payable to the regional budget. Besides the tax privileges, a number of other preferences are also offered to investors.

The benefits and preferences create favourable conditions for intensification of activities in the region for both Russian and foreign investors. This exerts positive influence on the region's competitiveness in attraction of investments. The adoption of the law "About public support to organisations..." undoubtedly has become one of the major factors that determined the growth of investment activities in the region in 2002-2003. The spirit and the principles, laid in the foundation of this law, fully correspond to the ideas of the programme document adopted in the same period "The strategy of socio-economic development of Kaliningrad Region as a region of cooperation for the period up to the year 2010", which set the long-term goals of regional development and the mechanism for their achievement, including the sphere of investment activities.

Meanwhile, the recent developments demonstrate a lack of consistency in the regional authorities' legislative activities. Rather contradictory situation is setting up with regard to attraction of investments today. Thus, the Kaliningrad Region law No. 347 of 27.12.2003 "About the regional budget for the year 2004" and the provisions of the Kaliningrad Region law No. 171 "About public support to organisations, implementing capital investments in the territory of the Kaliningrad Region", which are the basis for public support to investors, are suspended. This step has also resulted in the suspension of all local regulations, previously adopted in this sphere.

Thus, today, the inconsistency and, sometimes, the contradictory nature of the regional investment legislation are among the main factors constraining massive inflow of foreign capital to the regional economy. At present, the entrepreneurs planning to invest in the Kaliningrad Region can actually count only on using the opportunities provided by the Special Economic Zone regulations¹⁴. This is also testified by the negative dynamics of the region's investment rating. The investment risk in Kaliningrad is growing, and the most alarming is the fact that this is taking place on the background of positive changes in the investment environment in the North-Western Federal Area.

The inflow of investments is indirectly influenced by the legal norms regulating the relations established on the infrastructural level. These are primarily the legal relations connected with the allocation and use of land plots and production areas, which belong to the State or municipalities.

The legal regulation of the land relations is based on the Kaliningrad Region law No. 298 of 11.07.2003, with Amendments No. 351 of 9.01.2004 "On legal regulation of land relations in the territory of the Kaliningrad Region". This law delimitates the responsibilities in the sphere of land relations between the Kaliningrad Region Administration, Kaliningrad Regional Duma, and the executive body authorized to manage and dispose of the land resources in the Kaliningrad Region. The body is the Committee for management of public property of the Kaliningrad Region.

One of the practical documents realizing opportunities of legal persons and citizens in the sphere of land relations is, in particular, the "Procedure of granting of land plots for construction in the territory of Kaliningrad city" No. 400, approved by the decision of the Kaliningrad City Council of Deputies on 19.07.2002, with Amendments No. 424 of 04.12.2002, No. 258 of 25.06.2003, and No. 435 of 19.11.2003.

The very process of adoption of this document demonstrates the instability of legal acts, regulating the relations between investors and local authorities. Despite the fact that within one and a half years (from July 2002 to November 2003) the law was amended three times, today the Procedure is a document void of a clear algorithm of actions to be carried out by legal or physical persons planning to get a plot of land within the city bounds. The Procedure does not clearly stipulate the time within which the applications of the legal or physical persons must be answered, nor the time to be taken for preparation of the Mayor's directives on holding of tenders, nor the time within which the land plots should be provided, etc. The document does not specify actions to be carried out by local authorities, taking part in the execution of the formalities concerning land relations, which causes uncertainty about the procedure of provision of land plots.

The document contains provisions stipulating the procedures of tenders (auctions, contests), based on which land plots are to be provided for rent or ownership. The procedure of the tenders (auctions, contests) for the sale of land plots or of the right to conclude land rent contracts is regulated by the Provision adopted by Decision No. 285 of the Kaliningrad City Council of Deputies on 19.07.2002. However, at present, the effect of the Provision is suspended due to the protest of the Kaliningrad

¹⁴ We consciously do not mention the draft laws at the stage of development, frequently referred to by local politicians, because the contents of the documents have not yet been finalized.

Region Prosecutor's office (No. 7-12-03 of 16.01.2003), which pinpoints a number of clauses in the Provision that do not comply with the current federal legislation.

The analysis of the Kaliningrad Region legislation, directly or indirectly influencing the inflow of investments in the region, allows selecting the main problem in the way of intensification and enhancing of entrepreneurship in the region.

Among the principal barriers in the way of entrepreneurs' intentions to benefit from the potential privileges is the complicated system of collection and submission of documents required for getting the privileges as well as the need to be subjected to additional cameral and field inspections by the Control and Accounting Chamber of the Regional Duma and by an executive authority of the Kaliningrad Region, to check up the observance of the investment agreement terms and legal requirements by the investors. Finally, the shortcomings of the mechanism and procedures of settlements and tax collection, the performance of the tax departments, the instability of the tax legislation, and other administrative/fiscal barriers undoubtedly prevail over the benefits and advantages offered to entrepreneurs, and the costs of obtaining the privileges are often larger than the profits they can get by using them.

Unfortunately, the lack of a single and stable legislative system for attraction of investments into the region demonstrates that the attitude of regional authorities to this issue is not adequately attentive. Therefore, The enhancement of the investment attractiveness of the region and improvement of the investment environment could be achieved by means of development and legislative fixation of the main provisions and investment policy priorities in the Kaliningrad Region.

In ordering and further development of the regional investment legislation, it is necessary to take into account the recommendations of experts in the field of investment policy who propose allocating the directions of investments to be activated, based on division of investors into three categories: strategic, direct financial, and portfolio investors. An individual programme, determining and stimulating the interests of each group of investors, should be offered to each of the allocated groups.

Thus, the main directions of the activities for creating more favourable legislation in the region are as follows:

- creation of a single investment programme, agreed on the regional and municipal levels;
- creation of a single system of legislative acts to make the framework for a stable and clear mechanism for provision of concessions and preferences to investors, in order to establish uniform criteria for providing the benefits to investors independently from arbitrary actions of functionaries. They should stipulate clear conditions, the observance of which ensures provision of benefits to the investor;
- setting up of an infrastructure for the support to foreign investments by establishment of free consulting services within the licensing bodies; organisation of a network of "investment bureaus", that would provide procedural support to investment projects and ensure solution of disputable situations, which might emerge in connection with the implementation of investment project;
- minimization of the procedural burden on investors, connected with the necessity to collect numerous documents and to bear various additional types of costs, with the long procedure of approval of the documents by various regional bodies, and with the separate accounting for selecting the activities, relating to implementation of investment projects, etc.
- improvement of the procedures of operation of the administrative bodies, including adoption of regulatory acts, for example, of a Kaliningrad Region law "About protection of citizens and legal persons, applying to State organs of power and control".

3. Poland and Lithuania: direct foreign investments as a factor of enhancement of the export potential

In most countries, carrying out market economic reforms, direct foreign investments (DFI) are considered not so much as simple increasing of investment resources of the country and even not only as an opportunity to attract high technologies and administrative know-how. DFI are an efficient method of enhancement of the export potential, the more so where national producers are involved in stable technological and logistical schemes of transnational companies. According to the results of studies carried out by the Warsaw Institute of External-Trade Conjuncture and Prices, one percent increment of foreign investments in Poland leads – with a 3-quarter time lag to a 1.4-percent increase

of the physical volume of exports¹⁵. The index of correlation between the DFI increment and the growth of exports in many post-socialist countries of the Central and Eastern Europe is even higher (for example, in Hungary it is 3 times higher).

3.1. Poland

Among the East European states, in Poland the attraction of foreign investments creates the most appreciable impetus for an increase of exports, by the force of its influence prevailing over any other factor (capital investments of domestic investors, measures of the State support to exporters, the general-course policy, etc.). In the recent 10 years, the accumulated amount of foreign investments in Poland has grown manifold (see Fig. 8). According to the data from the Polish Information and Foreign Investments Agency (PIFIA), in the middle of the year 2003 it exceeded 68.3 mill. USD.¹⁶

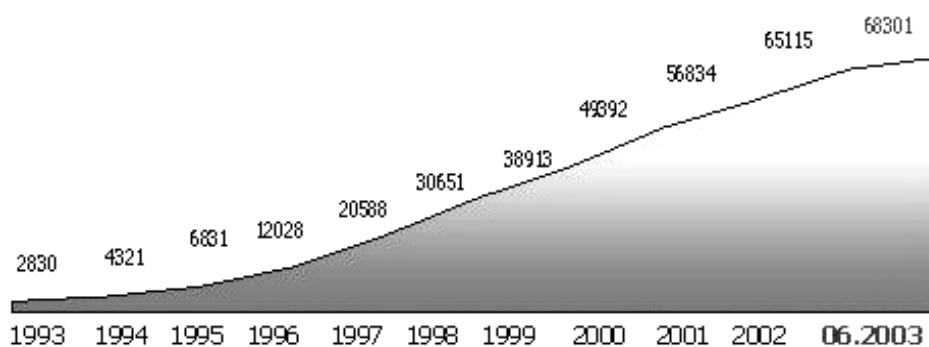


Fig. 9. Growth of accumulated direct investments in the Republic of Poland, million USD

Source: Polish Information and Foreign Investments Agency

Because of the deterioration of the economic conjuncture in EU countries and in the world as a whole, the annual inflow of DFI in Poland has essentially decreased. Their maximum volume reached achieved 10.6 billion dollars in 2000, and dropped by almost by half in 2003. Nevertheless, the country remains attractive for foreign investors. By the volume of DFI per capita among the Central and Eastern European countries it is only behind Czechia and Slovakia. Besides, positive changes are observed in the DFI structure in Poland: the specific weight of greenfield projects, that are considered to be the most profitable, has grown up to 37%. The advantages of greenfield projects consist in creating more additional workplaces not only in the new enterprises but also in the enterprises in contiguous sectors. Another positive trend is the growth of DFI in the processing industries up to 40%.

The leading investor-countries in Poland are France, the USA, Netherlands, and Germany (see Table 2 below).

Structure of accumulated foreign investments in the Republic of Poland
by countries of origin (as of 30 June 2003)

Table 2

¹⁵ See "Warunki działania sektora handlu zagranicznego", Warszawa, IKCHZ, grudzień 2002.

¹⁶ According to the Polish National Bank (PNB), the inflow of foreign investments in the country is substantially below the level shown by the PIFIA's data. The bank is monitoring the DFI by payment balance method, while the Agency uses surveys. For example, in 2002, according to the PIFIA, 6,064 mill. USD arrived in the country, but according to the PNB estimates the amount was 4,119 mill. USD. The Agency surveys only companies with DFI above 1 mill. USD. The structure of other DFI is only approximately estimated. Nonetheless, the PIFIA reflects the situation quite adequately. Besides, the accumulated investments are accounted by the Agency.

Country of origin	Accumulated investments, mill. USD	Specific weight, %%	Investment plans, mill. USD	Number of investments
France	12 528.8	19.4	2 153.6	92
Netherlands	8 906.4	13.8	780.3	106
USA	8 285.6	12.6	2 541.6	124
Germany	7 952.5	12.3	1 598.6	227
Italy	3 711.3	5.8	1 146.7	65
Great Britain	3 542.5	5.5	279.8	45
Sweden	3 033.2	4.7	288.4	58
International capital	2 176.0	3.4	737.0	16
Denmark	1 903.6	3.0	301.6	43
Belgium	1 901.5	3.0	398.9	25
Republic of Korea	1 471.8	2.3	5.0	4
Russia	1 291.9	2.0	350.0	3
Ireland	1 081.6	1.7	68.2	3
Switzerland	1 053.8	1.6	166.9	22
Austria	1 047.5	1.6	183.6	38
All countries	64 460.3	100.0%	12 599.8	993

Source: Polish Information and Foreign Investments Agency

Note: The table shows only investment projects exceeding above 1 mill. USD.

Among the companies, the leading investor is a French firm France Telecom (3,199.4 mill. USD), the principal shareholder of the major Polish telecommunication company Telekomunikacja Polska S. A. Actually, this single investment initiated the peak inflow of DFI in Poland in 2000. In the second place is the Italian Fiat (1,749.3 mill USD), whose interests have spread not only to motor industry, but also to insurance and banking services. Neither did the Korean concern Daewoo (1,452.3 mill. USD) limit its work with its traditional lines of activities (production of TV sets and automobiles), providing insurance services. The German Hypo und Vereinsbank (1,336.0 mill. USD) is the principal shareholder of the third largest Polish bank PBK S.A. (70% shares). Another foreign bank American Citibank (1,300.0 mill. USD) is a strategic investor of the Polish Bank Handlowy S.A. The last in the list of the largest foreign investors is the Russian "Gazprom" company (1,283.8 mill. USD), the principal shareholder of the EuRoPol Gaz S.A. (supply and distribution of gas, construction of engineering structures).

The principal investors determine the sectoral structure of the accumulated DFI in many ways (see Table 2). 40.3% of the total amount is invested in the manufacturing industries. The motor industry (including the manufacture of parts and assemblies) is leading. Foreign capital fully dominates here. Alongside with the above-mentioned Fiat it is the major investor General Motors (800.0 mill. USD) as well as Isuzu, Volkswagen, Toyota, and Volvo. Within a short period the companies are going to additionally invest 1 billion USD in this sector. Volkswagen has the most ambitious investment plans (250 mill. USD) and Toyota (180 mill. USD).

There are nearly no such major investors in the food/flavour industry, but due to the great number of investors the total volume of DFI is also large. The leading companies in this sector are American Coca Cola (513 mill. USD) and Philip Morris (500 mill. USD).

Table 3

Sectoral structure of accumulated foreign investments in the Republic of Poland

(as on 30 June 2003)

Sector	Volume, mill. USD.	Specific weight
Manufacture of finished industrial products, including motor industry	25 915.5	40.2%
food/flavour industry	6625.9	10.3%
	6033.9	9.4%
Credit/financial services	14 263.5	22.1%
Trading	7 786.4	12.1%
Telecommunication and transport	6 413.4	9.9%
Construction	3 005.8	4.7%
Energy-, gas-, water supply	2 556.5	4.0%
Other sectors	4 519.2	7.0%
Total	64 460.3	100.0%

Source: Polish Information and Foreign Investments Agency

Note: The table shows only investment projects exceeding above 1 mill. USD.

Direct foreign investments have played an important role in the creation of a modern market infrastructure in Poland (telecommunications, banking and insurance services, trading). These sectors have absorbed nearly as much DFI capital as the manufacturing industries (40%). The sectors, certainly, are of great importance for expansion of export opportunities of Polish economy, although this cannot be evaluated in precise quantity terms.

The presence of the foreign capital renders not only direct, but also mediate influence on the dynamics of the Polish export. For example, the expensive credit (the real discount rate in the country exceeds 5 %) brakes the processes of modernisation of manufacture and increase of competitiveness of Polish goods on foreign markets. In this situation one can note the tendency for active attraction of foreign credits, which by virtue of obvious reasons is more typical of firms with foreign participation. It even more strengthens the role of DFU as a major factor of growth of Polish exports.

There's more certainty about the influence of foreign investments for export of manufacturing industry products. According to data from the Warsaw of External-Trade Conjuncture and Prices, in 2002, 54.5% of all Polish exports were produced by firms with foreign participation, which made up 22.3 billion USD, and their specific weight in export is continuously increasing. Back in 1995 the aggregate volume of export by those firms amounted to only 6.9 billion USD, or 30% of all national exports. The main positions in the structure of the external-trade deliveries belong to machines and equipment (in 2002: 6.6 billion USD or 29.7%), the EU countries constituted the largest market (75.4%. or 16.8 billion USD, out of which Germany: 7.9 billion USD).¹⁷

Many firms with foreign participation are exclusively export-oriented. The motor industry can serve as an example. In 2003, this industry showed the highest growth rates. It reached nearly 4 billion USD. The largest enterprise in the industry Fiat Auto Poland exports up to 80% of its products, including automobiles. In 2002, 120 thousand out of 159 thousand. manufactured automobiles were supplied to external markets. The share of exports in such firms as Volkswagen Motor Polska and Isuzu Motors Polska is 100%.¹⁸

A similar example in another sector is the enterprise Daewoo Electronics in Pruskove city, which, during the recent 8 years, has been exporting 90% of the television sets manufactured in its factory (about 1.5 mil. pcs).

However, it should be noted that the companies with foreign participation in Poland are altogether are not only the largest exporters but also the largest importers. In 2002, their purchases abroad made up 32.,1 billion USD, or 58.2% of Polish import. Thus, the enterprises with foreign capital are net importers with an aggregate negative balance of about 10 billion USD. Это обусловлено, прежде всего, масштабным импортом этими предприятиями инвестиционных благ, сырья, материалов и комплектующих. It is caused, first of all, by the scale of imports by these enterprises of the investment values, raw materials, stock, and accessories. It should be noted that according to experts such situation is quite natural for the first stage of development of new production facilities. It is expected that in future the trend might change, and, after getting local suppliers in the country and optimizing the logistics, the firms with foreign participation would become net exporters of goods and services.¹⁹

3.2. Lithuania

The role of DFI as a major factor of enhancing of the Lithuanian export potential is probably even more significant than in Poland. The more so because many Lithuanian enterprises with foreign participation are tightly built-in in the technological chains, connecting them with the largest world corporations.

Back in the first half of the 90s, the DFI in Lithuania amounted to only 35-70 million rubles/year. This is primarily explained by the fact that immediately after restoring its independence the power was taken by right/nationalistic forces, whose ideology was largely populist. The privatization proceeded

¹⁷ See "Inwestycje zagraniczne w Polsce". Raport roczny, Warszawa, IKCHZ, 2003.

¹⁸ "Rynki Zagraniczne", No. 3-4 6-9.01.2004

¹⁹ See "Inwestycje zagraniczne w Polsce". Raport roczny, Warszawa, IKCHZ, 2003.

under a voucher scheme, which actually excluded arrival of strategic foreign partners. Foreign investors had an opportunity to participate only in commercial (monetary) privatization, that is to buy shares at the stock exchange. However such purchases did not represent real interest, due to the low level of liquidity and profitability of shares, and the impossibility to obtain the controlling block of stock.
20

The situation started changing in the second half of the 90s, after the beginning of implementation of a new model of privatization, which assumed the use of international tenders (about 1 thousand enterprises were put on sale). The inflow of direct foreign investments started rising. By October 2003, the accumulated volume of DFI made up 3.85 billion Euro, which was twice above the level of 1998 (see Fig. 9). Among foreign investors, a group of North- European countries are outstanding (as of 1.10.2003): Denmark (17.4 %), Sweden (15.5 %), Finland (8.5 %), and Norway (3.2 %). Scandinavia is followed by Germany (10.2 %), the USA (8.6 %), Estonia (7.7 %), Russia (5.0 %), the Great Britain (5 %), and Switzerland (3.1 %).

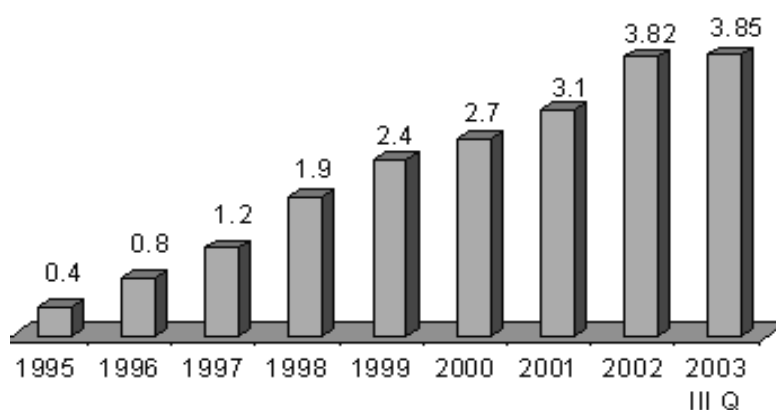


Fig. 10. Accumulated foreign investments in Lithuania, billion USD

Source: Department of Statistics of the Lithuanian Republic

The major investment priorities for attracting capital became evident. The main stake was made on the establishment of a modern economic and market infrastructure (transport, telecommunications, banking/insurance system), and on export-oriented specialisation of industries. The prepotency of Scandinavians among the foreign investors is determined by their investments in the telecommunication and banking spheres. At present, the major foreign investments (over 100 mill. USD) in Lithuania are:

- 590 mill. euros invested by the Swedish/Finnish consortium Amber Teleholdings Consortium (Telia/Sonera) in the telecommunication company Lietuvos Telekomas;
- 250 mill. euros invested by the Swedish bank SEB-Skandinaviska Enskilda Banken AB in the Vilniaus Bankas;
- 174 mill. euros invested by the Danish company TDC (Tele Denmark A/S) in the mobile communication company Bitė GSM;
- 150 mill. euros invested by YUKOS (through Yukos Finance, Gibraltar) in the Mazeikiu Nafta oil concern (53.7% shares), an oil pipeline and a marine oil terminal.

The similarity of the structures of the leading foreign investors in Lithuania and Poland is notable. In both countries a major western telecommunication company (or a consortium of such companies is evidently leading). Western banks are also present as well as a giant Russian fuels/energy complex. In the second echelon surely are transnational companies operating in the sphere of manufacture of food stuffs, tobacco, electronics, and light industry products.

Similar analogies can be noticed in the sectoral structure of the accumulated foreign investments. However, in Lithuania, the DFI share in the sector of services (telecommunication, banking, etc.) slightly exceeds the DFI share in the manufacturing industries (see Table 3). It can be assumed that in future the proportion will change, and the main DFI recipient in Lithuania (same as in Poland) will be the manufacture of finished industrial articles.

²⁰ See U. Udanov. Baltic region: Special features of shaping of a favourable climate for direct foreign investments. "World economy and international relations", 2003, No.3.

Table 4

Sectoral structure of the accumulated foreign investments in Lithuania
(as on 1 October 2003)

Sector	Volume, mill Euro	Specific weight
Manufacture of finished industrial articles	1154	30.0%
Trading	716	18.6%
Telecommunications	668	17.4%
Credit/ financial services	606	15.7%
Other sectors	708	18.3%

Source: Department of Statistics of the Lithuanian Republic

It is difficult to precisely quantify the influence of foreign investments in the telecommunications and banking sector for creation of favourable conditions for increasing the export potential. Nonetheless, it obviously exists. The direct influence of the DFI on the changes to the scale of export is more perceptible in the manufacturing industries.

After a certain shock, caused by the Russian financial crisis in 1998, in four years (from 1999 to 2003), the Lithuanian export grew up in value terms by 84% (see Table 4).

Table 5

Export from the Lithuanian Republic in 1997-2003

	1997	1998	1999	2000	2001	2002	2003
Export, mill. Euro	4476	4302	3483	4417	5314	5881	6395
Increment, % (previous year = 100)	115	96	81	127	120	111	109

Source: Department of Statistics of the Lithuanian Republic

In 2003, the main items of Lithuanian export were mineral products (19.7%), transport vehicles and transport equipment (15.2%), textiles and articles thereof (13.6%), machines and equipment (11.1%). They are followed by chemical products (6.6%), light industry articles (6.6%), wood and articles thereof (5.4), food industry products and tobacco articles (4.6%), products of animal origin (3.9%).

In 2003, the main partner of Lithuania in export activities was Switzerland (11.7%), through which Mazeikiu nafta, the oil concern, is exporting its products. The supplies to Russia made up 10.1% of all exports, to Germany 9.9%, to Latvia 9.7%. The total volume of exports to EU countries was 41.9%, EU candidate- member countries 19.3%, and to CIS countries 16.9%.²¹

The numerous examples available in various sectors of economy can testify to the character of influence of direct foreign investments on the development of the export potential of Lithuanian enterprises.

It was originally supposed, that DFI in Lithuania would help to generate export-oriented capacities in a number of traditional branches of the food/flavour and light industries in view of export of their products on the markets of Russia and other CIS countries. До последнего времени именно эти отрасли лидировали в привлечении зарубежных инвестиций и в экспорте. Until recently, these branches were in the lead in attracting foreign investments and in export. They have accumulated up to 20 % of the DFI inflow in the country or 2/3 of foreign investments into the manufacturing industries. Most of the leading manufacturers in this sector of Lithuanian economy already have got foreign partners.

Capital investments in the food industry can serve as an example. So, the American - Swiss company Kraft Jacobs Suchard has purchased 67 % of shares of the Kaunas chocolate factory (Kraft Foods Lietuva). The enterprise has gone through a period of complexities in its relations with the Lithuanian authorities. The latter insisted on obligatory use of local raw materials which, however, turned out to be more expensively than imported materials. Finally, a compromise was reached, the firm received a legal opportunity to use import raw materials, but only for export-oriented production (basically for CIS countries). The total amount of DFI in this enterprise has made 37 million Euro.

A similar situation developed with regard to the major producer of dairy products Mazheikiay dairy plant (Mazeikio pienas), whose controlling block of stock is owned by foreign investors.

²¹ Baltic News Service, 10.02.2004.

Another enterprise in this branch is the Panevezis dairy plant (Panevezio pienas), 35.3% of shares belong to a Latvian investment company Prudentia Ieguldījumu Parvaldes Sabiedrība (64.09% of its shares belong to a major Lithuania dairy company Pieno zvaigzdes. In 2003, the plant increased its export by 50% up to 6 mill. euros. The volume of production of this plant is undoubtedly not large, but the situation is analogous in many other small enterprises in the country.

In the tobacco industry the main role is played by the American firm Philip Morris, that has purchased 65.5 % of the Klaipeda tobacco factory shares for 42 million dollars. Together with additional investments into the creation of modern capacities, the total volume of the DFI has made 87 million euros. The new complex is focused on export of its products to other Baltic and CIS countries.

In the light industry, the majority of leading manufacturers was privatized and has already entered partner relations with foreign firms. So, the German group Tuch Fabrik Wilhelm Becker has invested nearly 25 million euros in the enterprises in this sector (subsidiary enterprise Eurotextil, etc.). The Italian company Marzotto s.p.a. has invested 13 mill. euros in this sector (Liteksas subsidiary enterprises).

The shares of the largest enterprise in the light industry Utenos trikotazas (a subsidiary enterprise in the garment industry, with its own distribution chain) belongs to the Scandinavian Baltic Development concern (46.47%) and to the European Bank of Reconstruction and Development (28.6%). Up to 90% of the Utenos trikotazas is exported. The Lithuanian/Norwegian garment factory Lelija also sells up to 90% of its output on external markets (mostly in Russia).²²

At the same time under the influence of foreign strategic partners the sectoral specialization of the Lithuanian economy essentially varies. The interconnected changes occur also to the structure of export where orientation to the markets European Union and its candidate member countries is increasing. This primarily concerns the enterprises of electronics, mechanical engineering, metal working which began to carry out the functions of sub-suppliers of manufacture components.

For example the German concern Siemens and the Japanese Yazaki together with Baltijos Automobiliu Technika have set up a subsidiary company SY Wiring Technologies Lietuva GmbH, manufacturing electrical equipment (ignition systems) for the French motor industry giant Renault. The volume of investments in this enterprise has made 31 mill. euros. All its products are exported to France and Spain (about 100 mill. euro). A contract with Renault has been signed up to the year 2008. Lesser-scale contracts have also been concluded in this sector, but as a whole they also substantially contribute to the enhancement of the country's export potential. Among them one can pinpoint:

- a subsidiary company Elektronika UAB (electronic equipment for automobiles, sensor devices, etc.), belonging to a large Swedish electronics manufacturer Accel;
- a subsidiary company Smitz Cargobull Baltic UAB, belonging to a German manufacturer of trailers Smitz Cargobull (plastic panels, cooling systems, etc.);
- a Swedish company Swedlit AB Baltija UAB (production of plastic parts for Volvo automobiles).

The products of those companies are fully exported.

Ninety percent of Lithuanian electronic industry articles are exported. The largest foreign investment in this sector has been the purchase of the Ekranas picture-tube (kinescope) factory for 29 mill. euros (Farimex S.A., Profilo Holdings, Switzerland/Turkey). 60% of the exports are supplied to Turkey. In 2001, Ekranas company signed an investment contract with the International Finance Corporation (MFC), stipulating the provision of two credit tranches amounting to the total sum of 14 mill. euros. In future, it is intended to convert the credit into the enterprise's shares. 35% of the shares of another major TV equipment producer Vilniaus Vingis belong to foreign investors (Talinvest Suprema Securities, Hansabank).

The same principle of investment partnership is used in the machine-building sector. The Danish company Odense Steel Shipyard Ltd. has invested 21 mill. euros in the ship-building yard in Klaipeda "Baltijos Laivu Statykla", by purchasing the control share holding. At present the enterprise is focused on the manufacture of metalworks. Up to 97% of its output (about 25 mill. euro) is exported to Denmark as well as Germany, Netherlands, and other countries.

A significant exporter is the largest ceramic tile producer in the Baltic countries Dvarcioniu keramika. The share of exports of its output has been growing in the recent years, and in 2003 made 56%

²² Baltic News Service, 05.02.2004.

(nearly 9 mill. euro). According to forecasts, in 2004, the enterprise's exports will increase by 37.5 %. The Gibraltar company Iberian Ceramics owns 33.4 % of the shares, the International investment fund Baltic Fund Securities 24,9 %, Abdulaziz Analysis of the-Bragim 5,4 %. It is one of typical examples of successful development of the foreign trade activity in the sector of medium-size business.²³

The changes in the Lithuanian export are also rendered by Russian investments. The Mazeikiu nafta, controlled by a Russian company YUKOS might be regarded separately, because the relation between investments and exports are not evident here (exports had been carried out before the arrival of foreign investors)²⁴. But Mazeikiu nafta is not the only large enterprise under the management of Russian companies. For example, the Russian "EuroKhim" concern controls the Lifosa plant, a major phosphate fertilisers producer in Baltic countries. About 90% of the phosphates, produced by the plant, are sold on foreign markets through an American company "Cargill", dealing with sales and production of fertilizers²⁵.

The experience of The Kaliningrad Region's neighbours shows that foreign investments are one of the main factors of economic growth, and, which is particularly important, are the motive force for developing the most competitive sectors. The active attraction of foreign investments has resulted in a notable growth of export from these countries, practically completely represented by processing sector products. Therefore the creation of special incentives for attraction of foreign investments is, in our opinion, one of the key conditions for effective development of the Kaliningrad region.

4. Recommendations on support to foreign investments in the Kaliningrad region

As it has been mentioned above, a primary factor determining readiness of a foreign investor to make an investment of his capital in this or another field of activity in the Kaliningrad region, is the investment climate existing in it. It represents a set of political, legal, economic, social, household, and other conditions, which finally determine the a degree of investment risk and their efficiency. Nowadays, the general positive background elements for creation of a favorable investment climate in the region are as follows:

1. Generally shaped Russian legislative framework, providing the main legal conditions for regular functioning of market relations, including the conditions in the sphere of foreign investments.
2. Favourable geographical position of the region as a subject of the Russian Federation, connected to the closeness to the European market.
3. Non-existence of ethnical antagonism in the territory of the region and a sufficiently high social stability;
4. The consistent commitment of the regional authorities to the course of implementation of market reforms.
5. The customs concessions stipulated by the RF Law "On the Special Economic Zone in the Kaliningrad Region".

At the same time, there are many problems in the region, the decision of which would fully promote to the improvement of conditions for foreign investments. These problems are sufficiently well known and as a whole can be summed up as the following basic aspects:

- *legal problems* (absence of stability of legal conditions for investment activity in the region; insufficiency of economic guarantees for foreign investors, potential within the framework of the regional legislation);
- *administrative problems* (complexity of obtaining documents, lawful privileges, and so forth, connected with investment and other business activity);
- *labour problems* (problems of discrepancy of the level of the labour skills in the region and investors requirements);
- *so-called 'support' problems* (lack of strategy for attraction of investments, lack of foreign investors support infrastructure; underdeveloped informational support to investment activities in the Kaliningrad Region, lack of a single and accessible real estate register for enterprises);
- *infrastructural problems* (lack of specially arranged industrial zones, deficit of prepared investment sites);

²³ Baltic News Service, 05.02.2004.

²⁴ 53.7% of the MN shares belong to the Yukos Finance company, registered in Holland, and 40.66% of shares belong to the Government of Lithuania.

²⁵ Baltic News Service, 14.01.2004

- *general Russian problems*, relating not to the Kaliningrad Region alone, but also to other Russian territories. The specific geographical position of the Kaliningrad region, namely, the closeness of the European Union countries, frequently results in the fact that foreign investors compare the strengths and weaknesses of the Kaliningrad region with those of the Lithuanian and Polish territories. As a result the region 'suffers' from the all-Russian problems more, than other Russian regions.
- In this connection, it is necessary to especially note the absence in the region (as well as in all Russia) of additional direct economic incentives for foreign investors, similar to those offered to investors in many other countries (grants for creation of workplaces, largely widespread in Europe, and in particular in the countries that recently acceded to the EU, grants for training and retraining of personnel, etc.).

Despite the success of recent years, the task of activation of investment activity in the territory of the Kaliningrad region has not lost its urgency. In our opinion, the preparation of conditions for attraction of foreign investments in the region should be given the central place. It is a complex and regular process, which requires a modern administrative approach fully supported by the regional and local administrations, and the main stakeholders. It is primarily based on understanding of investors' needs and problems, on improvement of the general quality of the business environment, and quality of a life in the region, and, therefore, on the settlement of the above-listed problems.

Why do we put the accent on the creation of conditions, and not on the direct territorial marketing of the region? Practice shows that far from all European regions, which applied great efforts for attracting investment, recovered their efforts and expenses. The highest return of funds takes place in regions with unique competitive advantages and stable conditions for attracting investors. In our opinion, because the Kaliningrad Region has no undisputable competitive advantages, and the territorial marketing requires great expenses, the return of which is not always guaranteed, the application of this measure in the conditions of the Kaliningrad Region cannot be efficient. On the other hand, creation of conditions for attraction of investments demands considerably smaller efforts, than territorial marketing. Usually, this measure is the first step in the process of attraction of investments.

Probably, the greatest problem of the Kaliningrad region today is that the region does not have neither a precise strategy for creation of conditions for attraction of investments, nor clear delegation of powers on this issue to a professional team capable of communicating with potential foreign investors in a comprehensible professional consulting language.

For this reason, the task of the EuropeAid project consists, in particular, in helping regional stakeholders realize the necessity to develop and consistently implement the regional investment policy, and to make the decisions, ensuring the most efficient ways of achieving its goals.

With this end in view, the policy towards foreign investments should take into account at least the following basic principles:

- to strictly follow the strategy of regional development, reflecting the seriousness and long-term intentions of the State, relating to the attraction of foreign investments, and to ensure investors's trust;
- to provide coordination of the basic provisions of the policy concerning attraction of foreign investments in all branches of authority on the regional level, as well as in the business community;
- to provide conformity of declarations and real actions; not to depend on tactical political changes; to contain a concrete programme of actions by the regional authorities responsible for shaping of the investment climate in the Kaliningrad region.

Taking into account the situation developed in the Kaliningrad region, the opportunities of the EuropeAid project and of the RDA, we propose below a system of actions, which can be recommended with a view of improvement of the system of support to foreign investments on the regional level.

Recommendations with respect to the organization of activity for improvement of conditions for attraction of foreign investments into the Kaliningrad region

1. To envisage assigning persons, directly responsible for creation of conditions for attraction of foreign investments of structural units supervising investment activity issues within the structure of the Regional Administration and Kaliningrad Administration (as the main centre of

investments in the region). It is essential that the persons should be really responsible people, that could spare time for coordination of these activities (by all means, it should not be adding a tenth function to existing nine functions of a functionary).

2. Prepare the required legal framework (in the form of formally adopted documents), in support of the administrative decision about the development of strategy (programme) of creation of conditions for attraction of investments, to be integrated in the existing regional strategy and in the programme of actions, currently in the process of development.

**POSSIBLE SUPPORT ON THE PART OF THE EUROPEAID PROJECT
“Support for Regional Development of Kaliningrad”**

From the very beginning the Project has been continuously coordinating its work with the Regional Administration in all directions, concerning the Project activities. The Project is ready to support the responsible official from the Regional Administration and to jointly development the actions for “Improvement of conditions for attraction of foreign investments”, including participation in the development of a programme of actions for creation of conditions for attraction of foreign investments.

The Project has already provided to the Regional Administration its recommendations, in which the creation of conditions for attraction of foreign investments is considered as one of the key priorities.

3. To determine the functions of the Regional Agency for foreign investments and to delegate the functions to an existing organisation, because the creation of a new greenfield Agency does no seem realistic.

**POSSIBLE SUPPORT ON THE PART OF THE EUROPEAID PROJECT
“Support for Regional Development of Kaliningrad”**

The Regional Development Agency (RDA), working in the Kaliningrad Region since 1999, a partner of the Project, might become a site for setting up of such a structure assuming the main functions, if they are delegated to it by the Administration. The Project includes a component for strengthening the RDA, envisaging on-the-job training, and, if necessary, could orient a part of the training to the direction “Attraction of investments”. During the recent 10 years the Project foreign experts worked and continue working, executing orders of European regions for attracting investors in their territories. Their unique experience could be transferred to the RDA.

4. To intensify the activities for extending of regional economic cooperation between the EU and Russia, envisaged by Article 73 of the Agreement on partnership and cooperation with the European Union. Assimilation of western experience of regional regulation of foreign investments, methods and forms of encouragement of regional development is especially important. In this connection, development of a package of measures for stimulation of regional cooperation of Russia and the EU is required on the federal level, and on the regional level – availability of people, who are ready to be engaged in the exchange of experience not during their off-work time but within the framework of their professional duties (for this reason delegation of the functions of attraction of investments to the Agency is urgently necessary).

**POSSIBLE SUPPORT ON THE PART OF THE EUROPEAID PROJECT
“Support for Regional Development of Kaliningrad”**

The project is ready to support development of proposals (for example, in to the InterReg programme) on organization of such cooperation between APP and similar organisations in neighbouring countries, as such activity is a task of the Project for strengthening of the RDA. The arrangement of such cooperation has already started. For example, with the aid of the Project, the RDA is included in the proposal “Trans-European Clusters”, presented by organisations from a number of European regions (including the Kaliningrad RDA) to the InterReg international programme. If a positive decision is made on the financing of the Project, the RDA will get the opportunity to use the experience and tools for support to sectoral clusters, applied in other regions.

In particular, the investment promotion tools and marketing of clusters, could be utilized and tested in the Kaliningrad Region.

Further on, a number of recommendations are outlined, the implementation of which is aimed to ensure an efficient flow of the investment process (from provision of information to support to individual projects).

5. The creation of the Kaliningrad Internet-portal primarily focused on potential foreign investors. As the minimal variant, an appropriately modernized working RDA site can be considered.

6. The publication (including publications on the Internet site) of The Guide for Investors and other materials required for investors in the Kaliningrad Region. For example, investors are usually interested in analyses of real estate for their business (the typology of real estate, including the quality of buildings and land plots for investment projects, analyses of regional proposals, rent rates and sale prices, typical terms of rent and sales of business real estate, demand for real estate in the region, analysis of the trends for the forthcoming years, etc.), the bank of data of the sites for investments, average wages, energy-carrier prices, possibilities for enhancing of the personnel skills, etc.

**POSSIBLE SUPPORT ON THE PART OF THE EUROPEAID PROJECT
“Support for Regional Development of Kaliningrad”**

The project and the are developing an informational platform for the RDA, with a section oriented to potential investors. The platform will be opened already in the year 2004.

Within the framework of the Project, the Guide for investors has been prepared for publication. The Guide for investors covers the main practical aspects of investments in the Kaliningrad Region. The edition contains current information about the socio-economic situation in the region and the components of the regional investment potential, detailed description of legal and other regulatory issues, influencing the entrepreneurship activity and shaping the business and investment climate in the Kaliningrad Region. Numerous addresses and references are provided, which can be useful for investors in their practical activities. An individual section of the Guide is dedicated to the conditions for foreign investors' activities in the Kaliningrad Region. It seems that this edition, integrating all primary information required by investors, will be a substantial contribution to the improvement of the investment climate and activation of investment activities in the territory of the Kaliningrad

7. Structurisation of the regional proposal to potential investors

**POSSIBLE SUPPORT ON THE PART OF THE EUROPEAID PROJECT
“Support for Regional Development of Kaliningrad”**

The Project has been developing and, in summer 2004, will open a structured database with export and investment proposals from Kaliningrad enterprises.

The database, established on the basis of the analysis of data, collected during the previous stages of the Project, will contribute to the search of trade and investment partners for Kaliningrad business. For this purpose, the database will include both business proposals and descriptions of investment projects, proposed for implementation by the Kaliningrad Region, presented as the Virtual One Stop Shop for Investors. The neighbouring EU member territories and other Baltic rim countries will become priority geographic regions in the search for partners.

It is supposed that the database will comprise:

- systematic information about Kaliningrad companies and their commercial offers;
- an automated search system, providing efficient search and exchange of information about the companies and proposals.

8. Assistance to the analysis and promotion of the most important commercially focused investment projects, including all-round consulting support (the financial analysis, the economic analysis, presentations for potential investors, and so on).

**POSSIBLE SUPPORT ON THE PART OF THE EUROPEAID PROJECT
“Support for Regional Development of Kaliningrad”**

Jointly with the RDA the Project will make financial and economic analysis of two potential investment projects. As for today, the first round of open selection of investment projects has been held, assistance has been provided to Kaliningrad companies in the process of presentation of documents (41 companies were supported). Twenty-two potential investment projects were submitted to the selection commission, eleven of which passed the minimal selection requirements (formal compliance of the documents, availability of a team for the project implementation, quality of the project materials presented to the commission, etc.). Four of the projects were selected for subsequent site visits. As a result, on completion of the work, the Project will prepare and transfer the methods of financial and economic analysis of investment projects to the RDA, and test the selected projects with potential investors.

9. Carrying out of regular investment promotion actions. The most efficient are the investments clearly oriented to this or another sector, together with active marketing strategy, developed for specific potential investors. The studies, based on the experience of 50 industrially advanced or less developed countries, have shown, that each dollar spent on investment promotion can generate a benefit of \$4 to the national economy.

POSSIBLE SUPPORT ON THE PART OF THE EUROPEAID PROJECT "Support for Regional Development of Kaliningrad"

Promotion support to export and investment is one of the principal components of the Project. In particular, the Project envisages:

- organisation of 8 trade/ investment promotion events, including trade missions to EU countries, meetings with potential investors in the Kaliningrad Region, etc. A real contribution of the Project in the framework of this direction has been the seminar "The RDA's role in assisting to foreign investors", held in the course of the visit by Lithuanian entrepreneurs in the Kaliningrad Region, as well as the meetings among 83 companies (23 Lithuanian and 55 Kaliningrad companies), organized in March 2004.

Besides, the results of the Project's activity will be:

- creation of a database covering at least 50 companies with proposals for cooperation;
- publication of a catalogue "Proposals from the Kaliningrad Region enterprises", etc.

The Project is assisting to the opening of a Business Information Centre (BIC) within the RDA. The opening of the BIC is scheduled for June 2004. However, it is necessary to take into account that the Project's time framework is limited. Therefore, in order to sustain the BIC's operation public funds, allocation of public funds should be planned in future.

The main actions for improvement of the and administrative conditions for stimulation of investment could be as follows:

10. Creation of a permanent Commission on foreign investment issues for improvement of the administrative regime of foreign investment regulation on the regional level. The functions of the Commission should include: ensuring coordination of the activities of structural units of the Administration and elective authorities in the sphere of attraction of foreign investments, based on proposals, prepared by the Agency for foreign investments; settlement of issues, connected with registration of companies with foreign investments; procedural support of investment projects, and provision of mechanisms for settling disputable situations, arising in connection with implementation of investment projects in the territory of the Kaliningrad Region.

11. Development stable and unified criteria for granting investment allowances, not dependent on transitory interests, and fixing of the provisions in the regional legislation.

12. Minimisation of the procedural burden on investors, involving all kinds of costs, in the course of passage of their project documents through various power structures.

13. Full restoration of the Kaliningrad Region law No. 171 "On public support to organisations, making capital investments in the territory of the Kaliningrad Region" (possibly, after making amendments to the law). Review, analysis, and updating of all regional and municipal legislation for regulation of investment activities in the Kaliningrad Region.

POSSIBLE SUPPORT ON THE PART OF THE EUROPEAID PROJECT

“Support for Regional Development of Kaliningrad”

The Project is planning to carry out the analysis of 10 municipal and/or regional acts and to present recommendations, allowing to strengthen business activity of enterprises. This work is carried out in close interaction with the Regional Duma, the Kaliningrad mayor’s Office, and other stakeholders.

Two or three acts, connected with improvement of investment attractiveness of the Kaliningrad Region could be accepted for a detailed analysis in the framework of the Project. If such decision is made by the stakeholders, the Project is ready to provide relevant recommendations and draft amendments to the laws.

14. Establishment of a comprehensive regional system of guarantees for the investment process, namely:

- a regional pledge/insurance fund,
- a Provision on Положения on insured events (events that can lead to failure of the investment project for reasons beyond the investor’s control, when a part of the invested funds must be returned to the investor);
- a Provision on the procedure of selection of investment projects to be covered by the guarantees;
- a regional investment insurance company.

The most important measures aimed at the provision of labour for investment projects and at the development of the labour market in the Kaliningrad Region could be as follows:

16. Carrying out of the analysis of the regional labour market, namely: studies of the correlation of the offer and demand on the labour market in the Kaliningrad region, and the analysis of the disproportion between the offer and demand and development of proposals on reduction of the gaps.

The preliminary analysis, carried out by European experts within the project EUROPEAID/114287/CSV/RU “Support for Regional Development of Kaliningrad” has shown that the greatest barrier in the way of growth of the Kaliningrad Region companies is the problem of availability of qualified workers. This problem is not inherent to the existing production enterprises and to the sphere of services: the shortage of qualified human resources seriously hampers the attraction of investments. It is well known that the availability of qualified personnel is the key factor in making decisions concerning placement of investments. This problem is especially important for small and medium-size business, because large companies frequently implement their own training programmes.

For instance, in December 2003, the EuropeAid project held seminars with a number of Kaliningrad companies, which directly declared that the problem of workforce is one of the principal handicaps for the growth of business. In particular, the companies gave the following examples:

- *the existing training programmes do not match the companies’ needs;*
- *the companies are not always consulted as to what specialists they will want in 2 or three years;*
- *or else, if the companies are consulted with, it is absolutely incomprehensible what measures are taken to adapt training to the companies’ needs. .*

Potential investors, that are even less than the existing companies informed about the situation, have to understand the picture on the labour market, in particular, the following information, presented in a format accessible for investors:

- *supply (demography, statistics, skills, existing public and private organisations, engaged in the training and re-training activities, etc.),*
- *demand (key sectors and employers, ‘decaying’ sectors, the level of wages by sectors, complexities with the search of workers),*
- *infrastructural problems, impeding access of employers to the labour market, namely: transport, housing, communication, and other problems).*

“Support for Regional Development of Kaliningrad”

The project is already carrying out such analysis, namely: the Project experts are performing analyses of the supply and demand on the labour market, of the gap between the supply and demand. Based on the results of the studies proposals will be prepared for reducing the gaps.

16. Preparation and dissemination of information about the labour market in a format that can be processed by potential investors.

POSSIBLE SUPPORT ON THE PART OF THE EUROPEAID PROJECT “Support for Regional Development of Kaliningrad”

The Project has planned the elaboration of such information, based on the labour market studies (as above). The information will be placed on the RDA Internet-platform in a format comprehensible to potential investors.

17. Development and implementation of a Programme of development of labour resources (manpower) in the Kaliningrad Region:

It appears, that the basic purposes of such programme should be:

- provision of the process (programme) of economic development of the Kaliningrad region with skilled manpower;
- reducing of the gap between the demand for labour resources (companies, sectors) and the supply side (the higher and vocational training systems, the retraining system);
- integration of the existing training programmes, and attraction of financial and expertise resources on the federal and regional levels, as well as international organisations for development and implementation of the Programme.

The process of development of the Programme should, in our opinion, envisage such basic stages as:

- a. *Manpower demand analysis (companies' needs – current, potential, latent, etc.). This analysis should be made in view of the selected priorities of economic development (companies with the biggest potential for growth, priority sectors for economic development – for example, tourism, manufacture of furniture, agriculture, etc.)*
- b. *Supply analysis. The existing local organisations engaged in training and retraining of personnel, as well as the organizations- intermediaries (labour resource agencies, etc.)*
- c. *Analysis of comparison with the labour markets in neighbouring European countries (Baltic countries). Position of Kaliningrad on the labour market in the Baltic area. The competition on this market (for instance, what do the Baltic countries and regions offer to potential investors in terms of manpower). Whether Kaliningrad has any competitive advantages, and where. What is required with respect to the market development? What experience should be utilized? What training/retraining programmes exist with the neighbours, how are they organized?*
- d. *Analysis of the gaps between the demand side and the supply side. In this respect answers should be received to the following key questions for understanding the status of the regional labour market:
To what extent the companies' needs of manpower (from the point of view of quantity and quality) are covered by the existing organisations offering curricula? What are the 'blank spots' - lack of matching specialisation, special courses? To what extent can the currently existing training organisations fill the blank spots? Is there a need to create/open new training institutions, are trainers available, and how could they be prepared? Is the labour market monitoring provided?
The analysis should be executed based on the information about relevant situation in the Baltic region including the adjacent countries.*
- e. *Preparation of a joint programme of development of labour resources. The programme can have several levels:*
 - *federal (for example, measures to provide labour resources for FTP projects);*
 - *regional – in accordance with the developed priorities of economic development of the Kaliningrad Region;*
 - *municipal;*
 - *companies/clusters of companies or sectors;*

- *international – for example, creation of a European/Russian sub-programme on manpower in the framework of the joint programme of economic development, potential future projects for Tacis and other donors.*

The program can include such sections and measures, as:

- *priorities of training/retraining of personnel based on priority economic development sectors ,*
- *plan of actions;*
- *establishment of a special fund for development of labour resources;*
- *development of a network of training institutions (new specialisation lines);*
- *development of a system of monitoring of labour resources and needs (including elaboration of a system of indicators);*
- *development of a system of long-term forecasting (foresight) of needs;*
- *labour resources infrastructure for investors.*

**POSSIBLE SUPPORT ON THE PART OF THE EUROPEAID PROJECT
“Support for Regional Development of Kaliningrad”**

The European and Russian labour market experts of the Project have already included this task in its schedule. Based on the analysis of the labour market supply and companies' needs, as well as on the short comparative analysis of the positioning of the Kaliningrad Region in the Baltic map of labour division and on comparison of the Kaliningrad Region with other Baltic regions, the Project and the RDA will present recommendations and an action plan for different levels (federal, regional, municipal, and other). It is planned that on the regional level the recommendations will be formulated in the form of a proposed programme of development of the labour resources market in the Kaliningrad Region.

Conclusion

In recent years, despite the high rates of foreign investment growth, Kaliningrad enterprises with foreign participation have not been playing a significant role in the regional economy. Beginning with the year 1999, the Kaliningrad Region held one of the last places in its Federal area with respect to the volume of attracted foreign investments, though according to the estimates by Russian and foreign experts the region is attractive to investors thanks to its natural and geographic conditions and availability of skilled labour it is attractive to investors. In view of attracting foreign investments, especially from Poland, Lithuania, Germany and Scandinavian countries, Kaliningrad can take advantage of the favourable opinion of investors about Russia as a whole, and its convenient geographical position. But this is evidently not sufficient.

One of the main reasons of the low investment activity is the position of the federal centre that is not always adequate with regard to the region. At present, there are no other stimuli for attraction of investments in the region, except for the customs benefits. In spite of the intense growth, the Kaliningrad Region's economy is devoid of transparency, predictability, and a system of incentives. It lacks an effective system of protection of investors' rights and property, the legislative framework is often inefficient, and the system of taxation is complicated and unfavourable to foreign business.

The accumulation of considerable investment resources in the territory, instead of pointed random investments, is impossible without a well-thought investment policy, to be developed and implemented through joint efforts by public authorities, local government bodies, businessmen, entrepreneurs, and the population of the Kaliningrad Region. In a more favourable investment environment, foreign investments – mostly direct foreign investments – can supplement the growing internal investments.

The basic output of our work is the provision of the recommendations on support to foreign investments in the Kaliningrad region. Given the status of the investment sphere in the region and the experience of other Russian regions and the countries adjacent to the Kaliningrad Region, the efforts should be primarily concentrated on improving conditions for attraction of investments into the region. We propose a number of effective measures for intensification of investment activities in the Kaliningrad Region, the absolute majority of which are within the competence of regional authorities and can be implemented, provided there are good will and public support. In their turn, the Project and the RDA have already made a certain contribution and are ready to continue their participation in the execution of a part of the work in this direction.

EU-Russia Cooperation Programme Backgrounder

EU-Russia Cooperation Programme (formerly known as Tacis) is a tool for practical implementation of the Partnership and Cooperation Agreement (PCA). Within the framework of the Programme exchange of experience is performed between Russia and the EU Member States in the widest possible range of cooperation areas important for both parties, including nuclear safety, finance, small and medium sized enterprises, local self-government, to name just a few. To date the Programme embraces over 250 projects and is the largest in the CIS countries . The amount of Russian and European experts participating in the Programme is equal. Over 1700 projects worth nearly 2.6 bn. euros were successfully implemented since 1991.